

INVESTMENT STRATEGY QUARTERLY

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Letter from the Chief Investment Officer Come Together

It has been 60 years since the Beatles signed their first record deal. The English rock group from Liverpool dominated the industry for nearly a decade – and long after that as individual performers. John Lennon, Paul McCartney, George Harrison, and Ringo Starr created timeless tunes and memorable messages that we can borrow today to portray our economic and financial market outlook.

Here comes the sun, or so we thought. As Omicron subsided, there were *smiles returning to the faces* that are now mask-free. But as the unprovoked Russian invasion of Ukraine escalated, surging commodity prices pushed inflation even higher – with few consumers saying “*it’s all right*” as they eyed higher prices in stores and at gas stations. While we still hope that Russia will *give peace a chance*, we believe Western nations will continue to *come together* to punish Putin’s actions. But despite geopolitical hotspots, rising interest rates, higher commodity prices, and an uptick in volatility we still think there will be *something in the way* the economy and financial markets *move* in the months ahead.

It does not take an avid fan to recognize the Abbey Road cover art, with the Fab Four striding along a zebra crossing outside their recording studio. Even non-economists worry the Federal Reserve’s (Fed’s) tightening cycle and gasoline prices could cause the economy to cross into contraction, but our Fab Four metrics suggest it is not on *Recession Road*. Resilient labor market conditions, healthy manufacturing, still-attractive lending standards, and advancing real-time activity metrics (i.e., airplane traffic, driving, restaurant activity) point to above-trend economic growth of ~2.5% for 2022. The sustained reopening and pent-up demand (particularly for services) should also keep us off a *long and winding road*. While the psychological impact of lingering \$4+ per gallon gas prices poses the greatest downside risk, we do not think it will outweigh these positive catalysts and cause the economy to lose its stride.

Count on Chairman Powell to *speak words of wisdom* as inflation is at the highest level in 40 years and the Fed can no longer *let it be*. The Russia-Ukraine crisis and climbing COVID cases in China have both worsened *times of inflation trouble*, leading the market to price in an additional eight-plus Fed rate hikes this year. While our year-end inflation target is higher than we originally thought, *it won’t be long* before inflation decelerates

from its recent pace. Our expectation is that the Fed will be less aggressive than the market anticipates, raising interest rates slowly and steadily through year end to maintain maximum flexibility in an economy that is incredibly interest rate sensitive. The Fed will also *often stop and think about* the yield curve (as an inversion often serves as a precursor to a recession), and will reduce its balance sheet as another means to unwind its ultra-accommodative policy this summer.

The 10-year Treasury yield will struggle to *get back, get back to where it once belonged*, as history shows it trends lower after each successive tightening cycle. Inflationary pressures and the repricing of rate hike expectations could lift it temporarily above 2.50%, but it won’t stay there for long before it eases back to the 2.25% level by year end. The high interest rate sensitivity of the economy and the attractiveness of yield-producing assets should limit how high interest rates can go. From a sector perspective, credit spreads have widened due to economic concerns rather than a deterioration in credit fundamentals or rising default rates. Since the economy is still on solid ground this recent move may be exaggerated. But are corporate bonds and municipals still potential opportunities for income focused investors? *Yeah, yeah, yeah.*

Since we disagree with the calls for a recession, US equities still have *the ticket to ride* higher. A robust macroeconomic backdrop, resilient earnings, attractive valuations, and positive shareholder activity should guide the S&P 500 to our year-end price target of 4,725. The Fed’s tightening cycle may cause further volatility, but historically, *life goes on*, as the bull market tends to last an additional 3.6 years and rally an additional ~100% after the first hike. From a sector perspective, we remain biased toward the cyclical sectors (Energy, Financials, and Industrials), but have dialed back Consumer Discretionary exposure as it tries to *carry the weight* of higher energy costs. Attractive valuations are the

rationale for our recent upgrade of Health Care. For long-term investors, we suggest exposure to small-cap equities as relative valuations are the lowest in 20 years and earnings estimates continue to trend higher.

European equities *need somebody (help!) not just anybody (help!)* as the crisis could cause stagflation (rising inflation with tepid growth). The tragedy has stunted tourism, pushed gas prices to nearly double US levels, put key imports in the crosshairs, and caused the worst European refugee crisis since World War II. Not to mention, Europe is still battling the pandemic. As a result, we continue to favor US equities over the other developed international markets. Emerging markets have also been adversely impacted by rising commodity prices and a resurgence in COVID cases, but compelling valuations may make select regions, like Asia, an opportunity for long-term investors.

You say you want an energy revolution, but this recent crisis has only revealed the deep global dependency on oil and gas. Some investors fear the events of the Beatles era might repeat themselves – hour-long gas station lines and astronomical prices. But the US is now much more energy independent, and the International Energy Agency has ~1.5 billion barrels of strategic reserves – enough to replace Russia’s export production for over six months. Since production around the world has not been reduced and there are no shortages, we believe we can say *goodbye*, *goodbye* to the recent calls for a conflict-induced price of \$150+ per barrel. In addition to an eventual (hopeful) resolution in

Ukraine, increased OPEC and US production should moderate prices toward \$95 per barrel by year end. Ultimately, higher energy prices should accelerate the global development and adoption of alternative energy sources such as solar and wind.

Despite the recent volatility, we still believe the economy and markets can be *full steam ahead* by year end. We’re hopeful for a peaceful resolution and rebuild for Ukraine so that the devastation ends. It would also validate the historical precedent of geopolitical conflicts being short-lived events so long as they do not coincide with a recession. In the meantime, we encourage you to *get by with a little help from your financial advisor*. *All you need is confidence in a comprehensive financial plan when these difficult times arrive*, so that emotionally driven decisions can be avoided.

Overall, we remain optimistic for the world, US, and financial markets. As John Lennon so eloquently sang, *“You may say I’m a dreamer, but I’m not the only one. I hope someday you’ll join us. And the world will live as one.”*

All the best.



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Chief Investment Officer, Private Client Group

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Equity Sector Performance During Federal Reserve Tightening Cycles

Nicholas Lacy, CFA, *Chief Portfolio Strategist, Asset Management Services*

With the US Federal Reserve (Fed) and other central banks going down the path of increasing policy rates, it seemed a good time to look at market impacts over the last 40 years or so. Since 1984, there have been six cycles where the Fed raised the fed funds rate multiple times. Each time the Fed raised rates, it was based on a different set of circumstances; however, there were usually some similarities in each cycle. Bear in mind, it takes time for rate hikes to work through the economy, yet the markets are attempting to forecast the impact one year out.

Historically, the Fed has raised interest rates as a way to cut pricing pressures that could lead to higher inflation. In each instance in which the Fed raised rates in the last 40 years, inflation was moving to a higher point and unemployment was at, or below, the natural level of unemployment. On average, the unemployment rate has been 5.5% when the Fed started the rate hike cycle, with the 4.2% unemployment rate in 1999 being the lowest rate. When the Fed started raising rates in March of 2022, the unemployment rate was approximately 3.8% and below the 4.0% target the Fed set. The big difference in 2022 is

the level of inflation which is the highest since 1982. How this impacts sector performance going forward compared to the past remains to be seen.

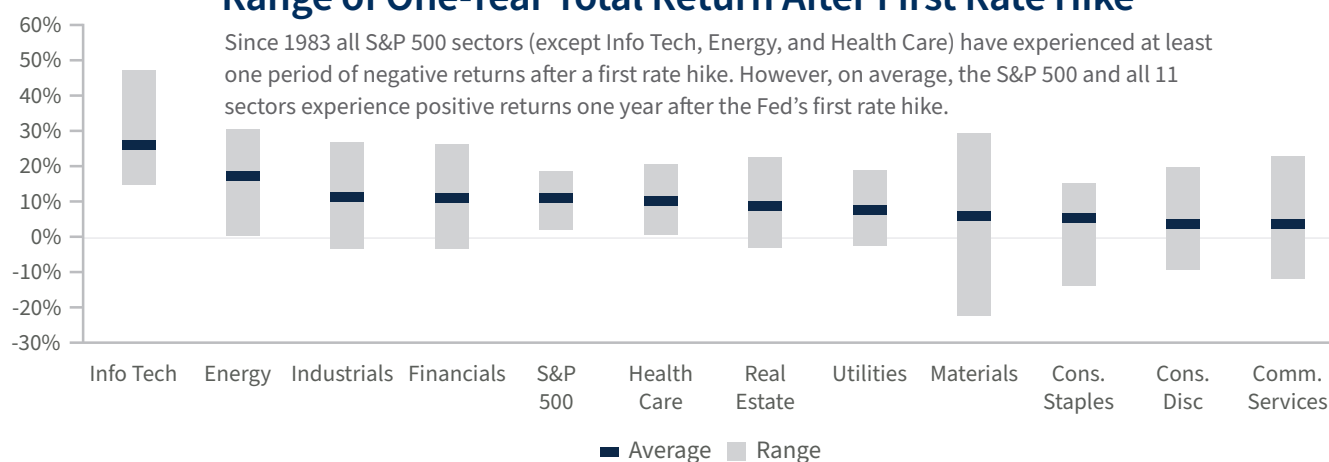
Sector performance varied from cycle to cycle but there were some constants. For example: most sectors were positive one and two years out from the first time the Fed started to hike the fed funds rate. The Information Technology, Energy and Industrials sectors have outperformed, on average, one year from the time the Fed starts hiking. At the same time, Communication Services, Consumer Discretionary and Consumer Staples have been the worst performing sectors. Many believe that financial stocks always perform well during rate hike cycles because banks benefit from higher rates. This may be true, yet, historically other sectors have tended to perform better. The chart at the right shows the ranges of one-year returns from the point the Fed starts hiking rates as well as the average returns. Most sectors have seen at least one period of negative returns. Information Technology, Energy, and Health Care are exceptions.

Looking beyond sectors to market segments; large/small and growth/value, small caps and growth stocks had the highest return one year following the first rate hike. While value stocks

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Range of One-Year Total Return After First Rate Hike

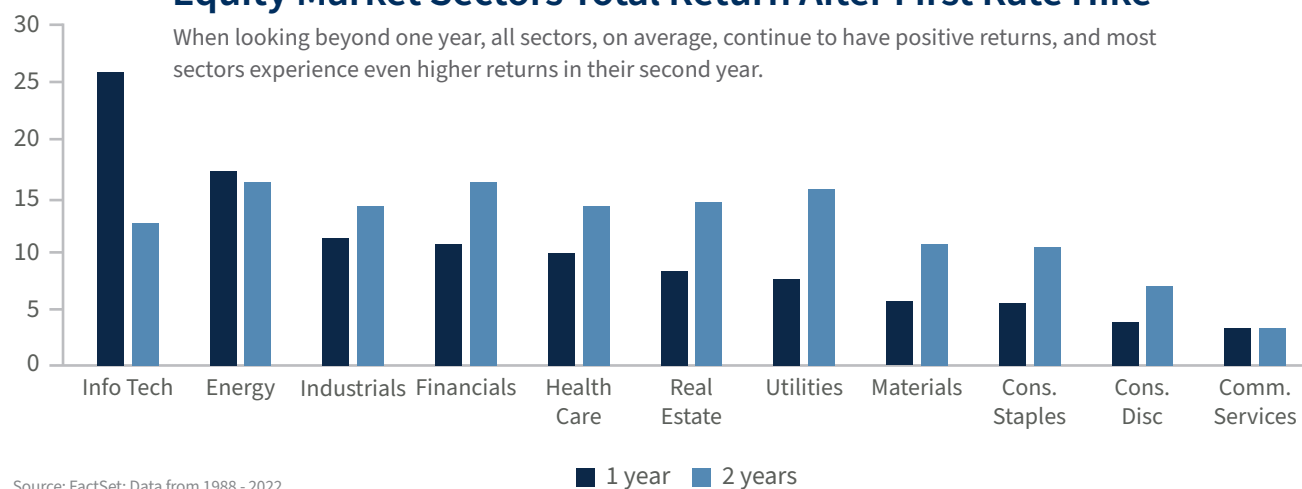
Since 1983 all S&P 500 sectors (except Info Tech, Energy, and Health Care) have experienced at least one period of negative returns after a first rate hike. However, on average, the S&P 500 and all 11 sectors experience positive returns one year after the Fed's first rate hike.



Source: FactSet; Data from 1988 - 2022

Equity Market Sectors Total Return After First Rate Hike

When looking beyond one year, all sectors, on average, continue to have positive returns, and most sectors experience even higher returns in their second year.



Source: FactSet; Data from 1988 - 2022

Market Segments: Total Return After First Rate Hike

Small cap and growth segments tend to outperform in the first year after a rate hike, while value tends to experience the best returns the second year after a rate hike.



Source: FactSet; Data from 1988 - 2022

Summary of Rate Hike Cycles

FIRST HIKE	LAST HIKE	STARTING RATE	ENDING RATE	10-YR YIELD START	10-YR YIELD END	CPI START	CPI END
12/15/2015	12/20/2018	0.12	2.35	2.22	2.78	0.44	2.17
6/25/2003	6/29/2006	0.75	5.25	3.38	5.20	1.89	3.98
6/03/1999	5/16/2000	4.75	6.50	5.80	6.46	2.09	3.01
2/04/1994	2/01/1995	3.00	6.00	5.94	7.66	2.45	2.87
3/04/1988	4/17/1989	6.50	9.75	8.28	9.20	3.94	4.89
5/24/1983	7/24/1984	8.50	11.63	10.56	13.31	3.48	4.33

Source: FactSet

had a positive one-year return, they trailed the broad market and growth stocks. It was two years after the first rate hike when value stocks started showing the strongest returns. The same thing can be seen for two years from the first rate hike where Financials, Real Estate stocks, and Utilities have tended to be strong relative performers.

Looking out more than one to two years from the first rate hike, little changes as Energy, Financials, and Utilities posted the strongest returns while Communication Services, Consumer Discretionary, and Consumer Staples were still the worst performing sectors. Markets were still positive two years out with small caps continuing to beat large caps, while value outperformed growth by a small margin.

History teaches us that stocks generally continue to perform well two years out from the first rate hike yet leadership shifts as the length of time extends. When the Fed starts hiking rates, it is normally good for equity investors for the next 12-24 months before economic conditions start to slow enough to increase the probability of a recession. Investors in the stock market should have some degree of confidence that markets don't fall apart just because the Fed starts hiking rates, and the negative impact is normally smaller than what one might think. ■

KEY TAKEAWAYS:

- There have been several rate hike cycles in the US over the last 40 years.
- Each rate hike cycle was driven by a different set of economic circumstances.
- In most cases, equity markets tended to have positive returns one and two years out from the first rate hike.
- Historically, Technology, Energy and Industrials tended to have the highest returns compared to Communication Services, Consumer Discretionary and Consumer Staples which underperformed, but still had positive total returns.
- Investors in the stock market should have some degree of confidence that markets don't fall apart just because the Fed starts hiking rates.



What is the Federal Reserve: Goals and Tools

Scott J. Brown, PhD, *Chief Economist*, Raymond James

The Federal Reserve (Fed) is the central bank of the US. It was created by Congress in 1913 to prevent financial panics. Its responsibilities have grown over time. While sometimes referred to as the unofficial fourth branch of government, it is quasi-governmental – independent, but answerable to Congress. The Fed is made up of the seven-member Board of Governors in Washington, DC and 12 Federal Reserve Banks around the country. The Fed governors are appointed by the president and confirmed by Congress, with terms of 14 years. The Chair, Vice Chair, and Vice Chair of Supervision (also governors) are appointed to four-year terms. The 12 regional bank presidents are appointed by the boards (composed of private citizens) of each of their individual banks.

One of the Fed's main tasks, and the one most critical to financial markets, is monetary policy – the setting of short-term interest rates to achieve the optimal performance of the economy. The Federal Open Market Committee (FOMC), made up of the Fed governors, the New York district bank president, and four other

district bank presidents (who rotate in January), sets monetary policy. While only FOMC members vote on monetary policy, all senior Fed officials participate at policy meetings.

The Fed also supervises and regulates banks, promotes consumer protection and community development, and works to ensure stability in the financial system. The Fed acts as a bank to other banks, clearing checks, making electronic payments, and providing currency.

MONETARY POLICY GOALS

In regard to monetary policy, the Federal Reserve Act states that the Fed “shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy’s long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

The Fed interprets “stable prices” as low, but positive, inflation. This gives the Fed some room to support the economy with low interest rates during a recession and allows inflation-adjusted wages to adjust downward during periods of economic weakness. In January 2012, the Fed followed other central banks in formally

adopting a 2% inflation target (as measured by the Personal Consumption Expenditures Price Index), although it had an implicit target of 1.7% to 2.0% before that.

The employment goal is maximum sustainable employment. There is no specific target for the unemployment rate. The belief has been that using monetary policy to push the unemployment rate lower would eventually lead to inflationary pressures. In fact, the dual mandate of stable prices and maximum employment is taken largely as a single operational objective – the job market will perform better over the long run if inflation is low and stable.

After a comprehensive public review, the Fed revised its monetary policy framework in August 2020. One problem with the 2% inflation goal was that it was seen by the markets as a ceiling rather than a target. As a consequence, inflation would average less than 2%. In the revised framework, the Fed moved to a flexible average inflation-targeting system. The long-term inflation goal remains at 2%, but following a period with inflation below 2% (as in the pre-pandemic years), the Fed would seek a period with inflation moderately above 2%. Needless to say, the timing of the shift in the framework was terrible (given the increased inflation pressure seen over the last year).

In conducting its review, the Fed talked to a wide range of businesses, academics, and the general public. One thing that stood out was that low-income communities were very slow to recover from the 2008 financial crisis. Black unemployment rises

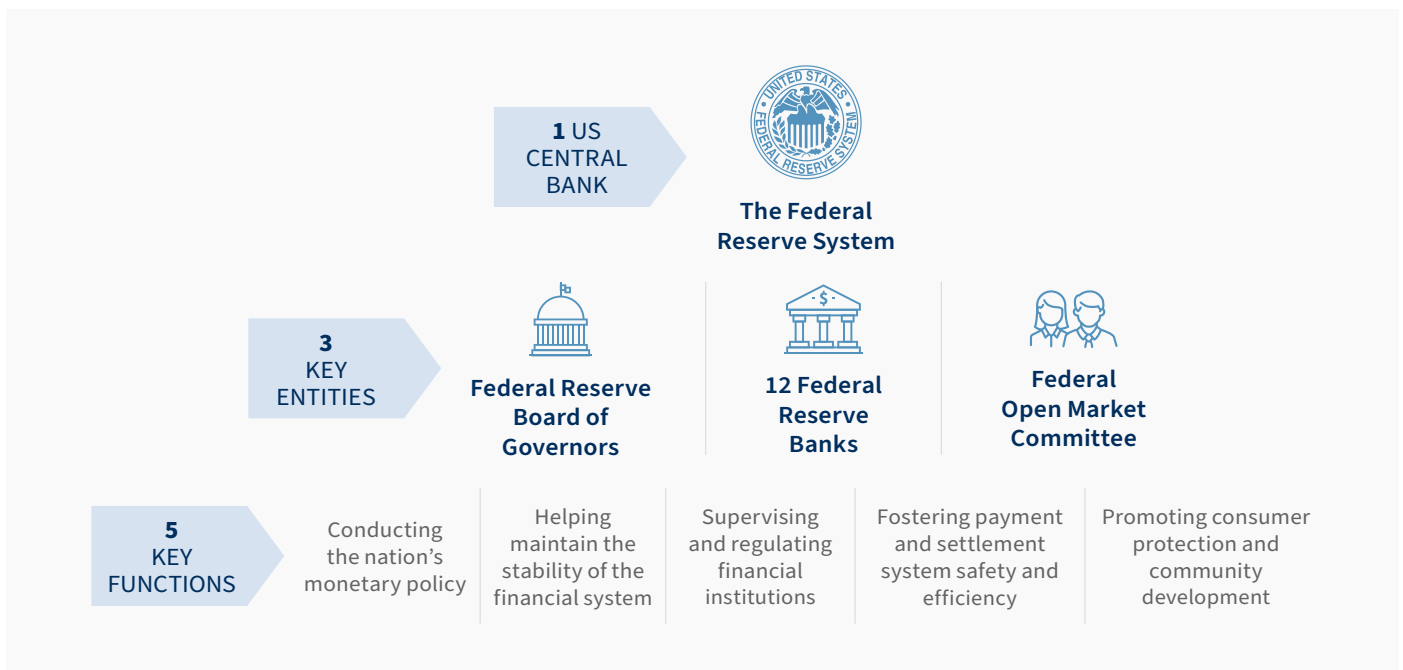
The dual mandate of stable prices and maximum employment is taken largely as a single operational objective – the job market will perform better over the long run if inflation is low and stable.

faster than white unemployment during a recession and falls more slowly in an economic recovery. The Fed made its employment goal “broad-based and inclusive.” Maximum employment is viewed as “not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market.” In setting monetary policy, the Fed assesses shortfalls in employment from its maximum level and considers a wide range of labor market indicators.

The Fed recognizes that these goals may sometimes be in conflict. Under such circumstances, the Fed will make a judgement call based on how far away it is from each individual goal, and how long it would take to reach those goals.

MONETARY POLICY TOOLS

The primary tool for monetary policy is the federal funds rate, the overnight lending rate that banks charge each other for borrowing reserves. Reserves are balances held at the Fed to satisfy banks’



Source: Federal Reserve

Monetary Policy Tools

Open market operations

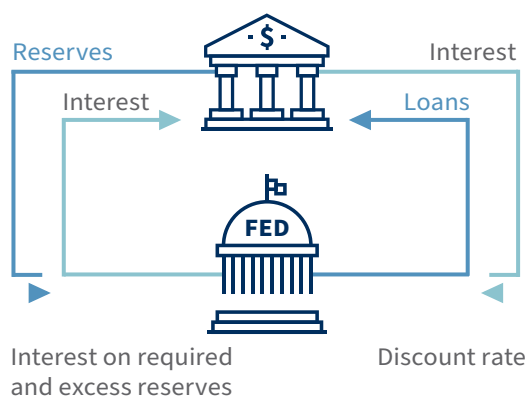


Buy or sell

Reserve requirement



3% or 10% of demand deposits



Source: Federal Reserve

reserve requirements. Banks with excess reserves can lend them to banks that need larger reserves. The federal funds rate is a market rate. The Fed sets a target range and performs open market operations (buying or selling Treasury securities) to achieve it (hence, the name ‘Open Market Committee’). The federal funds rate (and where it appears to be headed) affects longer-term interest rates. In raising the federal funds rate, the Fed ‘tightens’ the availability of credit. Lowering the federal funds rate ‘eases’ credit conditions.

The primary credit rate (sometimes still called the discount rate) is the rate that the Fed charges banks for short-term borrowing. The Fed’s Board of Governors approves (or not) a request for a change in the primary credit rate made by one or more of the federal district banks. Typically, the primary credit rate is changed at the same time as the federal funds target. Note that the FOMC only began to announce changes to the federal funds target in 1994. Before that, the discount rate, a posted rate, was viewed as the main policy signal.

The Fed sometimes employs forward guidance, a conditional commitment to keep the federal funds rate low for a certain period of time or until some economic objective has been achieved. These promises help to keep long-term interest rates low, promoting growth.

During the 2008 financial crisis, the FOMC lowered the federal funds target range to 0-0.25%. Seemingly out of ammo, the FOMC began its first Large-Scale Asset Purchase program (LSAP), which is more commonly called quantitative easing (QE). In quantitative easing, the Fed buys large amounts of Treasury and mortgage-backed securities each month. The Fed employed QE1, QE2, and QE3 in the aftermath of the financial crisis, and restarted asset purchases on a massive scale in the early stages of the pandemic. The Fed’s asset purchases helped lower long-term interest rates, although they seemed to become less effective at each stage. Unwinding the balance sheet will work in the opposite way, raising long-term interest rates.

The Fed’s asset purchases have ballooned the size of its balance sheet to nearly \$9 trillion (it was below \$1 trillion before the financial crisis and around \$4 trillion before the pandemic). The FOMC expects to begin unwinding its balance sheet later this year. That will occur naturally over time, as the FOMC reinvests a portion of maturing securities. The FOMC does not plan to sell securities out of its portfolio outright, although it will be buying and selling across maturities as the size of the balance sheet declines. The ultimate size of the balance sheet is uncertain; however, it will be based on maintaining an adequate level of reserves in the banking system.

MONETARY POLICY IN PRACTICE

In theory, monetary policy uses the money supply to influence employment and inflation, but the money supply plays no role in policy decisions. As Chair Powell testified in 2021: “The connection between monetary aggregates and either growth or inflation was very strong for a long, long time, which ended about 40 years ago. It was probably correct when it was written, but it’s been a different economy and a different financial system for some time.”

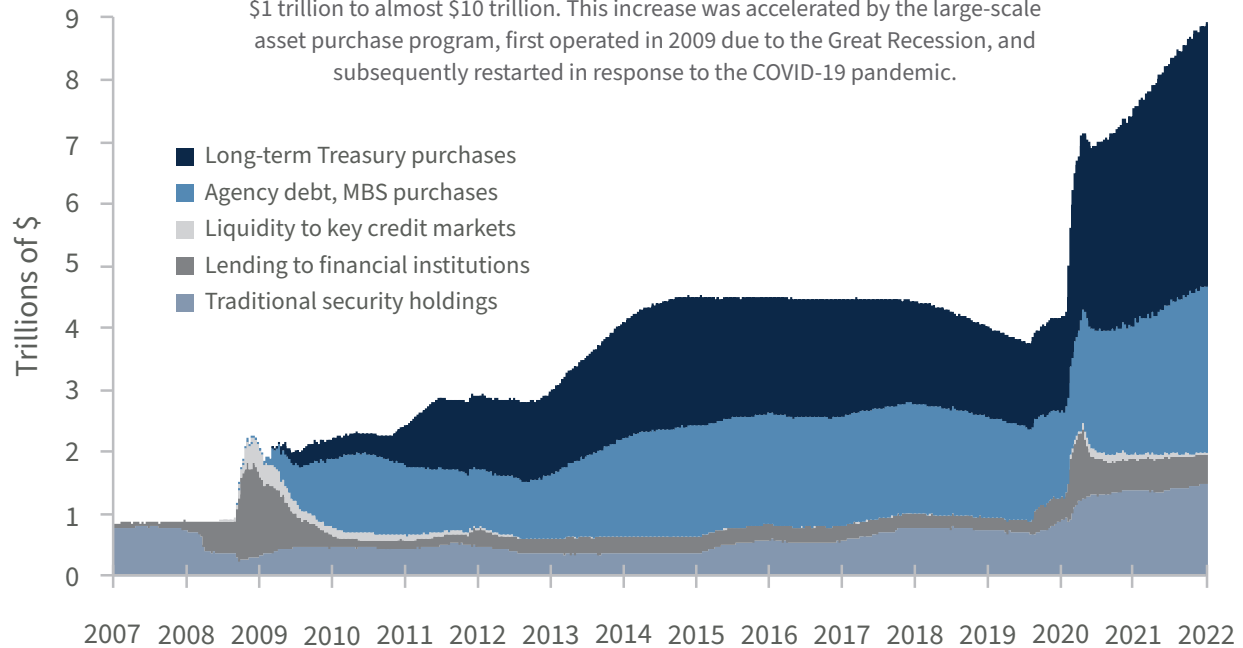
Policy decisions are based on a wide range of information. The Fed doesn’t react to the economic data per se, but to what the data imply for the outlook ahead. Economic data are subject to statistical noise and seasonal adjustment quirks and are often revised. The Fed also relies on anecdotal information collected by the district banks to gauge labor market conditions and inflation pressures.

The FOMC arrives at its policy decisions by consensus. Officials are in touch with each other before policy meetings and a decision rarely hasn’t been worked out in advance. Occasionally, one or two FOMC members may formally dissent in favor of tighter or looser policy.

Monetary policy affects the economy with a long and variable lag. It may be a year or more before the full effects of a policy change

Federal Reserve Balance Sheet at a Record

Over the last 15 years, the Fed's balance sheet has increased ten-fold from under \$1 trillion to almost \$10 trillion. This increase was accelerated by the large-scale asset purchase program, first operated in 2009 due to the Great Recession, and subsequently restarted in response to the COVID-19 pandemic.



Source: Federal Reserve, as of 3/31/2022

are felt. Hence, monetary policy is akin to steering a supertanker. Policy changes tend to be gradual. However, rate cuts tend to come faster than rate increases.

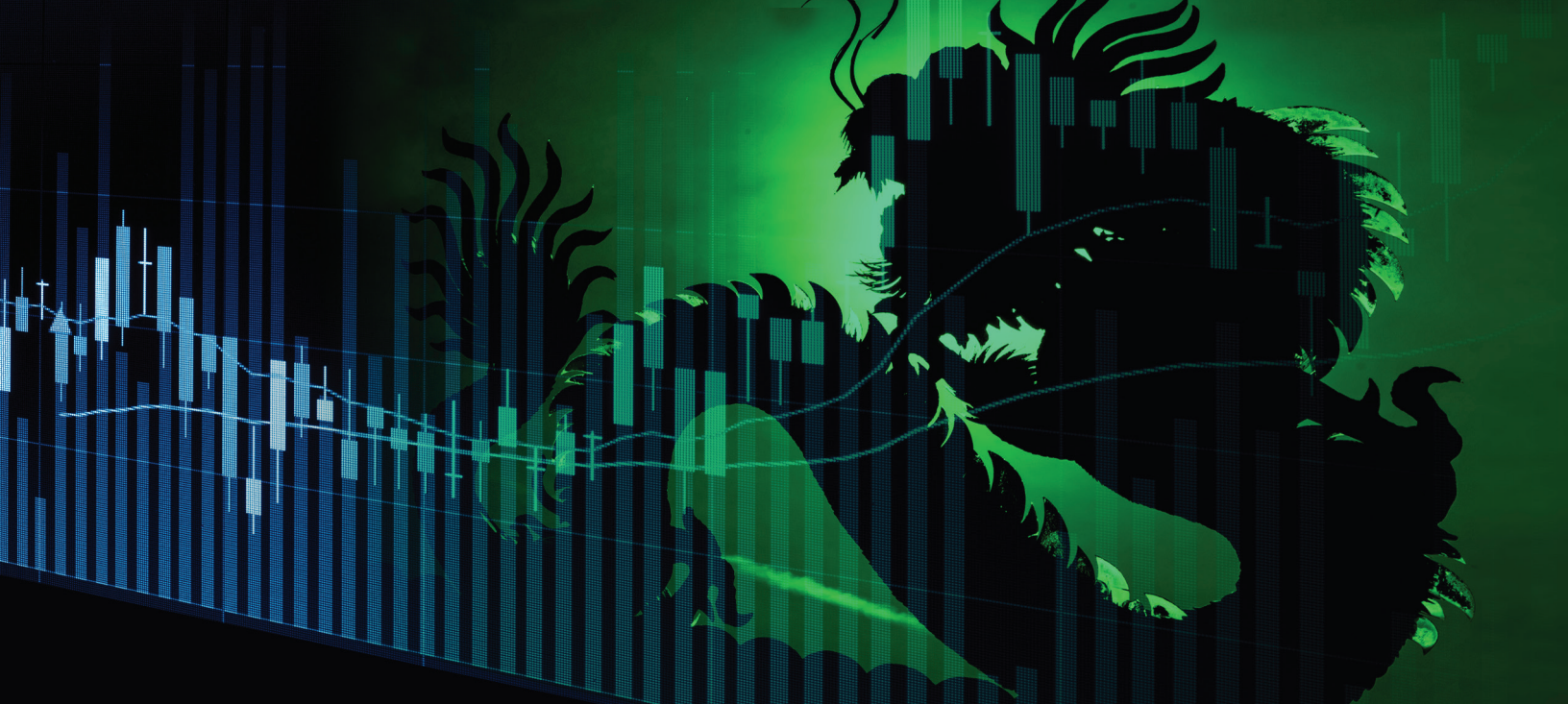
The Federal Reserve is firmly committed to achieving the goals that Congress has given it. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures. On March 16, the FOMC raised the federal funds target range by 25 basis points (to 0.25-0.50%) and signaled a more aggressive outlook on rate hikes into 2023. Of the 16 senior Fed officials, 12 anticipated raising the federal funds target range by an additional 150 basis points or more by the end of this year, and most expect another 75 basis points or so in 2023. However, none of this is written in stone. In his press conference following the FOMC meeting, Chair Powell admitted that, in hindsight, the Fed should have begun tightening policy sooner. Powell indicated that the FOMC could raise rates more quickly if appropriate. If inflation fails to moderate as the Fed anticipates, we could see much tighter monetary policy in the months ahead.

The oil shocks of the 1970s and early 1980s are associated with recession as well as higher inflation. While higher oil prices do not cause recessions, in the past, the Fed reacted to higher oil prices by raising interest rates and tighter monetary policy led to recession. Fed policymakers now know that the central bank should

not respond to temporary supply shocks. However, because monetary policy affects the economy with a lag, there is a chance of overdoing it and raising rates too much, possibly leading to a recession in 2023, but the odds of that are still relatively low. In the early 1980s, the Volcker-led Fed purposely steered the economy into a recession to reduce inflation. A similar outcome may be possible in the current situation, but inflation was much higher in the early 1980s and long-term inflation expectations have remained well anchored. ■

KEY TAKEAWAYS:

- The Federal Reserve (Fed) is the central bank of the US. It was created by Congress in 1913 to prevent financial panics and, over time, its responsibilities have grown.
- The Fed's dual mandate is stable prices and maximum employment, and its primary monetary policy tool is the federal funds rate.
- Policy decisions are based on a wide range of information. The Fed doesn't react to the economic data per se, but to what the data imply for the outlook ahead.
- Monetary policy is akin to steering a supertanker.



Q&A: Compelling Opportunities in Today's Markets

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

Doug Drabik, *Managing Director*, Fixed Income Research

Tracey Manzi

Q: Where do you see opportunities in the global equity markets?

A: We think Asian emerging market equities continue to look attractive. With monetary policy transitioning toward tightening throughout most of the developed markets amid higher inflationary pressures, conditions could not be more different across Asia. Not only is inflation lower across most countries in Asia, but the People's Bank of China is the only major central bank that is easing rates right now. While China's economy suffered from a policy-driven slowdown last year, the government is now prioritizing stabilizing growth ahead of Xi Jinping's leadership conference later this year. In order to rekindle growth, Chinese authorities are now pursuing more stimulative fiscal and monetary policies, which should be supportive of Chinese stocks as the economic growth outlook starts to improve.

From a valuation standpoint, Chinese equities are attractive, trading at approximately 11 times forward earnings and near a 40% discount to US stocks. While some of this discount is justified by Chinese equities' lower relative earnings growth, the

contrast in policy settings should prove to be a tailwind in 2022, and beyond, which should help narrow this gap. We are also constructive on other Asian emerging market (EM) equities, such as Taiwan, Korea and India, as we think they are poised to benefit from longer-term secular trends in technology, e-commerce and digital payments. While EM Asia's 2021 performance was disappointing, we are more optimistic on the region as we move through 2022 for three key reasons: 1) China, the main engine of growth in the region, is returning to a pro-growth policy, 2) cheaper valuations should provide a buffer as the market transitions away from more expensive stocks, and 3) the regulatory headwinds that plagued the market in 2021 are no longer the top priority for government officials.

Q: What opportunities do you see in the emerging markets debt sector?

A: The onset of the Federal Reserve's tightening cycle and geopolitical tensions have pushed spreads on dollar-denominated

emerging markets bonds close to 400 basis points, the additional yield compensation an investor receives for owning a riskier credit, and yields to well above 5.5%. Historically, these levels have been attractive entry points for investors. Since 2010, there have only been a handful of occasions where emerging market bonds have surpassed these levels. These periods include the 2011 European debt crisis, Russia's annexation of Crimea in 2014, China's 2016 growth slowdown and during the 2020 Coronavirus pandemic. In the 12 months following each of these periods, dollar-denominated emerging markets bonds delivered strong, positive total returns. Given the modestly wider spreads and higher yields available in emerging markets, we believe it is an opportune time to begin selectively adding some risk.

We are also starting to warm up to local currency emerging markets debt. While developed market central banks are just starting to normalize monetary policy, the tightening cycles in emerging markets are well underway. Central bankers in Latin America and Emerging Europe were among the first to respond to the escalating inflationary pressures that emerged late last year. Significantly higher interest rates across Latin America are taking a toll on growth now that rates are well above their pre-pandemic levels in most countries across the region. In fact, two of the largest economies in Latin America, Brazil and Mexico, slipped into a technical recession, which is defined by two consecutive quarters of declining economic growth, last year. While the growth slowdown suggests we may be nearing the end of the

tightening cycles in some emerging markets, we think central bankers will be reluctant to respond to growth concerns as long as inflation remains elevated. We are carefully watching how this dynamic plays out as we believe there may be attractive opportunities in select local currency markets in the months ahead.

Doug Drabik

Q: Why bonds in this market?

A: There is typically a tradeoff observed between investment types. Striving for strong alpha (beating the market averages) will likely come with additional risks of some sort. For decades now, added market volatility risk has been offset by the positive total return effects of falling interest rates and tightening credit spreads. Money managers and individuals alike benefitted when market prices generally moved higher. It also helped managed money by diminishing timing effects on liquidations. Most bonds exhibited profits throughout their holding periods. Tightening spreads created pricing tailwinds. These tailwinds vanish when interest rates rise, and spreads widen. Total return bond strategies may be strapped with added challenges in a generally rising interest rate environment. Higher yields and spread widening can create an opportune time to increase fixed income holdings which provide principal protection and steady cash flow – regardless of market volatility or geopolitical events.

Emerging Markets Asia Poised for a Rebound?

In addition to its already cheaper valuation, with China instituting pro-growth policies and relaxing its regulations, we are optimistic on the region for 2022. As China makes up ~40% of the MSCI Emerging Markets Index, we expect a positive performance to have a huge impact on the broader index.



“Ten-year investment-grade corporate bonds and municipal bond yields as a percentage of Treasury rates have surpassed five-year average spreads, while high yield bonds have flirted with their five-year averages.”

Q: Should I be concerned about falling bond prices?

A: Investors have a natural predisposition and sensitivity to their investment portfolio holdings' price performance. Observing a security's negative price change can be emotional and maybe even traumatic. After all, poor price performance can be damaging to one's financial health and place an investor in the undesirable circumstance of having to 'make up' a loss of principal or hard-earned income. Price declines' unwelcome effects apply to many growth and total return strategies; however, with individual bonds, there are key differences. As interest rates rise and individual bond prices fall, there is no interruption or reduction to the bond's cash flow and income stream. Interest rates have risen with intermittent swiftness since the start of 2022. When a portfolio displays 'red' figures on individual bonds, remember the primary purpose of these holdings is often principal protection and balancing a portfolio strategy. Despite the negative market price movement, this portion of the portfolio maintains cash flow, yield and principal when held to maturity, barring an unlikely default.

Q: Where are the opportunities in fixed income?

A: Since the start of 2022, buyers of spread products have realized a twofold improvement. First, Treasury rates are up meaningfully year-to-date. The two-year Treasury is up 156 basis points (bp) on the year moving from 0.73% at year end (December 31, 2021) and more than doubling to 2.30% as of March 31, 2022. The ten-year Treasury is up 81 bp from 1.51% to 2.32% over the same time period. Inflation has been a primary driver but there are offsets, not the least of which have been geopolitical events such as the Russian/Ukrainian war. We continue to anticipate

that 2022 will bring higher interest rates versus last year, yet not high historically. Regardless, higher rates translate to higher yields.

Second, spreads have widened appreciably since the end of 2021. Spread widening has been more of a technical function as bonds pull away from the spread compression experienced during the pandemic. Ten-year investment-grade corporate bonds and municipal bond yields as a percentage of Treasury rates have surpassed five-year average spreads, while high yield bonds have flirted with their five-year averages.

There are many uncertainties at play such as continued geopolitical events (pandemic, war), inflation, yield curve inversion, and monetary policy. The favored range or 'sweet spot' we believe resides in or around the two to seven year maturity for corporate bonds, primarily in the BBB credit space. For investors seeking longer durations, we like higher credit quality options as they reflect a strategic choice that anticipates spread widening in lower tier credits, which we believe is still down the road.

Tax-exempt buyers can take advantage of municipal bonds at a higher percentage of Treasury rates than they have in recent history. Ten-year AAA municipal yields as a percent of ten-year Treasury yields have gone from 69.5% on December 31, 2021 to 97% on March 31, 2022. Higher yields will benefit income investors. Ten- to twenty-year municipal bonds with 4% or higher coupons and calls inside six years should provide superior yields and shorter durations. Should interest rates rise and the durations drift up, the higher coupon provides cash flow and income shelter. ■



The Oil Market Is NOT Just a Russia Story: Supply/Demand Fundamentals Are What Matter

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

For our readers with investments in the oil value chain, the fact that oil prices reached fourteen-year highs in the early spring of 2022 helps explain the Energy sector's outperformance year-to-date, building on its gains from 2021, when it had been the best sector in the S&P 500. On the other hand, the oil market rally is also contributing to the global economy's inflationary spiral, with consumers as well as businesses feeling the pain of high prices at the fuel pump. Whether we like it or not, high oil prices are here to stay. We forecast that West Texas Intermediate (WTI) crude will average \$100/barrel (Bbl.) in 2022, with only a modest cool-off to \$90/Bbl. in 2023. For some perspective, as recently as December 2021, WTI was in the low \$70s. Brent crude, the global benchmark, should remain a few dollars above WTI.

GEOPOLITICS AND THE OIL MARKET

There is no disputing the fact that geopolitical factors played a major role in the oil market rally of recent months. The prime example is the crisis that culminated in Russia's invasion of Ukraine. Why does this matter for the oil market? Because Russia produces approximately 11 million barrels per day, or 11% of the

It is equally true that the underlying oil market fundamentals – good ol' supply and demand – are as bullish as they have been over the past decade.

world's oil supply – on par with the US and Saudi Arabia – of which 7.5 million barrels per day (bpd) is exported, including 4 million bpd that is sold into European countries. Russia's natural gas production – three-quarters of which goes to Europe – is even more of a geopolitical hot potato. Thus far during the war, oil and gas pipelines have continued to operate normally. Also thus far, sanctions have had only a peripheral effect on Russia's energy sector. Germany has made it crystal clear that the Nord Stream 2 gas pipeline – an \$11 billion project owned by the Russian gas giant Gazprom – will be blocked from operating for the foreseeable future. The US has imposed an embargo on Russian oil, and the U.K. and Poland plan to do so by year-end 2022, but unless the rest of Europe follows suit, it won't mean much in practical terms.

Separate and distinct from Russia/Ukraine, other geopolitical hot spots that contribute to high oil prices include Libya (the plan to hold a presidential election has broken down); Yemen (the Houthi

rebels continue to fire missiles into neighboring countries); and Iran (progress in negotiations toward a new nuclear agreement is uneven, at best).

SUPPLY AND DEMAND FUNDAMENTALS

It is equally true that the underlying oil market fundamentals — good ol' supply and demand — are as bullish as they have been over the past decade. Our global oil market model points to inventories declining by approximately 2 million bpd in 2022. When inventories are declining, by definition it means that demand is outstripping supply. Demand in 2022 is back to the pre-COVID peak of 100 million bpd. Meanwhile, OPEC has remained very consistent with its roadmap of gradually bringing production back to pre-COVID levels by September 2022. Capital spending by the world's oil and gas companies is finally recovering from the ultra-austere levels of 2020-2021, but the industry's commitment to capital discipline is firmly in place. Management teams are accommodating long-standing shareholder demands for less production growth and instead more emphasis on dividends and share repurchases. Even for those companies that are willing to substantially increase capital spending, it will take time for drilling activity to provide a meaningful boost to supply. For

“The war has dramatically raised the issue of energy security on the agenda across Europe.”

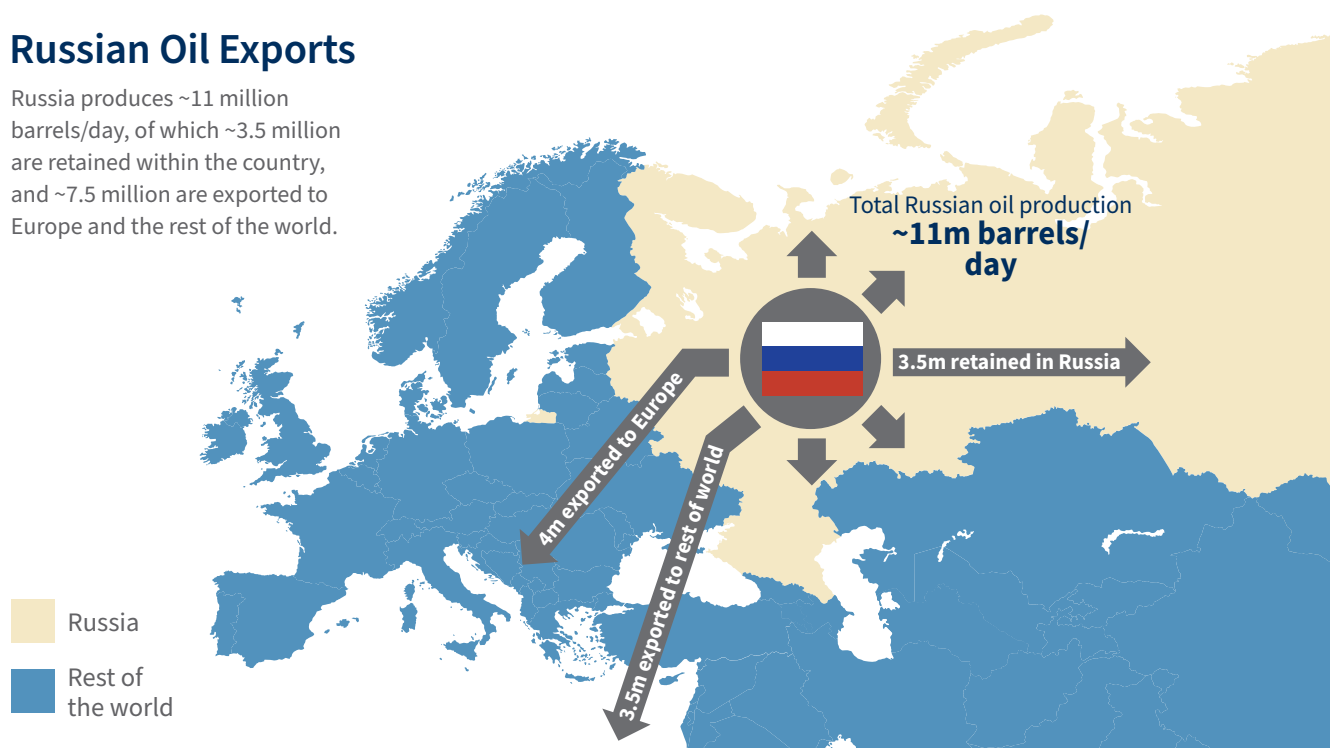
North American shale, production uplift will remain muted until 2023. For oil-producing regions with mostly long lead time projects, such as Brazil and West Africa, it will take even longer.

ENERGY TRANSITION

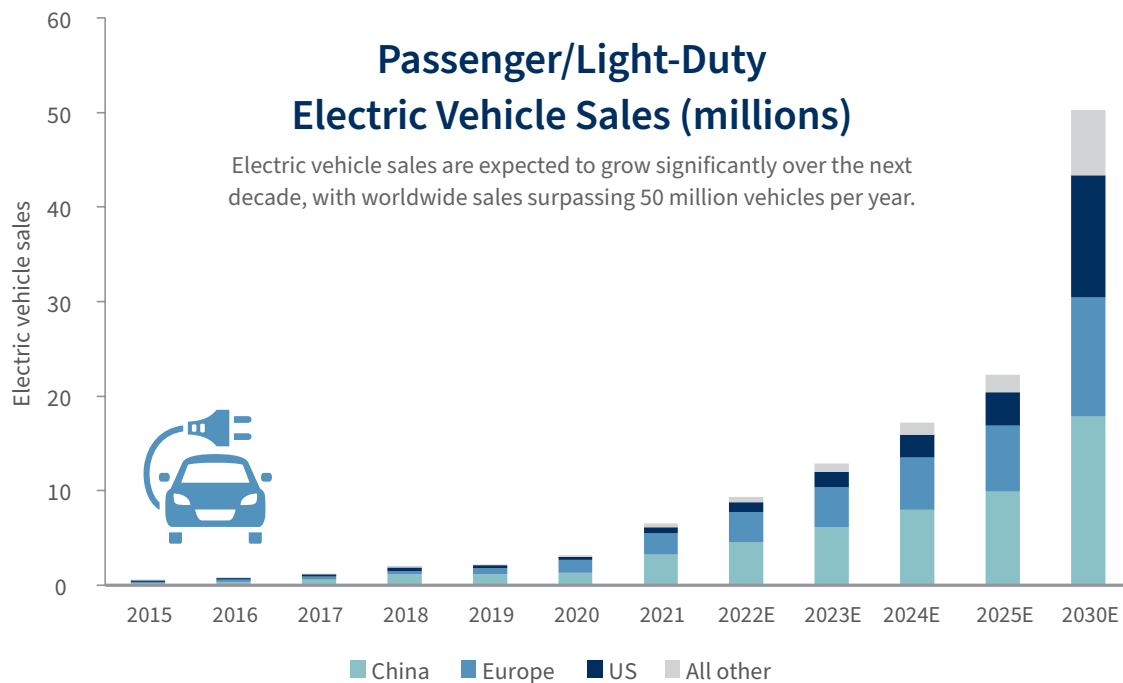
The oil industry may be tempted to celebrate that good times are back again, and indeed it is the case that profitability and free cash flow metrics are currently very strong. But high oil prices on a prolonged basis will carry an unavoidable side effect: accelerating the energy transition, away from fossil fuels. Government policies vis-à-vis climate change (such as carbon taxes and petroleum phase-outs) are already pointing consumers and

Russian Oil Exports

Russia produces ~11 million barrels/day, of which ~3.5 million are retained within the country, and ~7.5 million are exported to Europe and the rest of the world.



Source: Raymond James Research



Source: Raymond James Research

businesses toward low- and zero-emission alternatives. Oil prices at fourteen-year highs are compounding the effect of climate policies, as the economics of electric vehicles look more attractive than they did just a few years ago. As it relates to Europe specifically, there is also the geopolitical urgency of shifting away from Russian oil. The war has dramatically raised the issue of energy security on the agenda across Europe. Germany, whose new coalition government includes the Green Party, is taking the lead: targeting 15 million electric vehicles (EVs) on the road by 2030, which is approximately equivalent to what the entire world currently has. EVs in Germany had a market share of 26% in 2021 (among light-duty auto sales) – the highest of any G20 economy. By comparison, the US was at only 5%. If Germany reaches its 2030 EV target, it would have the effect of erasing the need to buy Russian oil ever again.

Taking a global perspective, we forecast light-duty EV market share increasing from 8% in 2021 to 25% in 2025 and 50% in 2030. Alongside the demand boost from high fuel prices, expansion of consumer appetite for EVs is being driven by the declining cost of lithium-ion batteries, longer range of those batteries, and a broader array of model choices across the price spectrum. Interestingly, though, the adoption curve is progressing more rapidly in buses as compared to the car market. China is the standout leader in electric buses, though Europe and the US are

moving in the same direction. Electrification of trucks is at a very early stage, but if it follows the trajectory of buses, this will imply rapid transformation of truck fleets into the second half of this decade. It is worth noting that sustaining rapid growth in EV sales will require an equally aggressive buildout of charging infrastructure, especially the DC ultra-fast chargers that can make it as convenient as filling up a conventional car at a fuel station, i.e., a mere five to ten minutes. ■

KEY TAKEAWAYS:

- High oil prices are here to stay. We forecast that West Texas Intermediate (WTI) crude will average \$100/Bbl. in 2022, with only a modest cool-off to \$90/Bbl. in 2023.
- Russia is a major producer of oil and natural gas. Three quarters of natural gas production goes to Europe.
- High oil prices will accelerate the transition away from fossil fuels.
- Along with higher gas prices, consumer appetite for electric vehicles is being driven by high oil prices.

Economic Snapshot

The US economy entered 2022 with good momentum. The outlook remains positive, but uncertainty has increased. Job growth has remained strong. Inflation has remained elevated, and price increases have further broadened across sectors. The Federal Reserve (Fed) has begun raising short-term interest rates and is now signaling a more aggressive outlook for rate increases in the quarters ahead, but will be nimble. Russia's invasion of Ukraine has uncertain implications for the US economy, but will likely weigh against growth and add to inflation pressures in the near term.

DR. SCOTT BROWN
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	GDP growth is expected to moderate (relative to the strong pace of 2021) but remain a bit beyond a long-term sustainable pace in 2022.
	EMPLOYMENT	Nonfarm payrolls are still below where they were before the pandemic, but labor demand is strong. Higher oil prices and better wages should lure many of those on the sidelines back into the workforce.
	CONSUMER SPENDING	Job and wage growth should remain supportive, although wages are generally not expected to keep pace with inflation (implying some reduction in consumer purchasing power).
	BUSINESS INVESTMENT	Business fixed investment is expected to remain strong, supported by continued strength in earnings. However, the situation in Ukraine and expectations of tighter Fed policy may be restraints.
	MANUFACTURING	Supply chain difficulties, materials shortages, and labor issues have continued, restraining output growth in a number of industries, but we should see improvement over the course of 2022.
	HOUSING AND RESIDENTIAL CONSTRUCTION	Housing demand remains strong, but supply and affordability issues are constraints. Mortgage rates have picked up (although still relatively low by historical standards).
	THE DOLLAR	The trade deficit is likely to widen further, putting some downward pressure on the dollar (if not offset by increased capital inflows). However, a stronger US economy ought to be supportive over the long term.
NEUTRAL	LONG-TERM INTEREST RATES	Despite elevated inflation, bond yields remain low by historical standards. Bond yields ought to rise as the Fed begins unwinding its balance sheet.
	FISCAL POLICY	A reduction in fiscal stimulus (compared to the massive levels of 2020 and 2021) will subtract from GDP growth in 2022, but the impact should be more than offset by increased private-sector demand.
	REST OF THE WORLD	The virus is still a factor globally. The conflict in Ukraine will have a bigger impact on Europe's economy than in the US. Inflation is higher everywhere, which is a bigger problem for emerging economies.
UNFAVORABLE	INFLATION	Elevated. Price increases have continued to broaden. We ought to see some rollback in prices of consumer durable goods, but inflation in services (which account for more than half of spending) has been picking up.
	MONETARY POLICY	Behind the curve on inflation, the Fed has begun to raise short-term interest rates and is expected to move faster if inflation fails to moderate. This raises the risk of overdoing it, leading to a possible 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.

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*.

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

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	HEALTH CARE	13.6%	Although the double-digit decline for the S&P 500 may discount the current challenging equity market headlines, we upgraded Health Care to Overweight as a defensive measure with uncertainty high and market momentum weak. In addition, attractive valuation, with the relative P/E one standard deviation below the 15-year average, provides an incentive to use the sector as a hiding place. We see attractive opportunities ahead with specific subsectors, such as elective care, set to benefit this year and beyond on less stringent COVID headwinds.
	FINANCIALS	11.5%	We remain Overweight Financials. Although the yield curve may continue to flatten as macro uncertainty builds, Fed tightening will keep the shorter rates well bid. The higher short rates boost profits by pushing interest rates higher on loan balances (which are also improving). Earnings revisions continue to move higher across the sector while valuation remains attractive.
	INDUSTRIALS	7.9%	We remain Overweight the Industrials for now. The invasion of Ukraine adds a potential headwind to the global macro and already slowing PMI data that could shift our opinion on this manufacturing exposed sector. A higher US dollar is another headwind. Nonetheless, for now, the newfound interest in the aerospace/defense subsector, which is the largest weighting in the sector at 20%, gives us a cushion to monitor the situation further. Fundamentally, earnings revisions are trending lower for 2022 while flattening for 2023. Relative valuation (EV/EBITDA) below the 15-year average provides modest support to our Overweight position.
	ENERGY	3.9%	The war between Russia and Ukraine, even if it ends soon, will keep energy prices elevated as a geopolitical risk premium will likely remain for the foreseeable future. Despite the currently elevated prices, OPEC and US energy producers are signaling discipline with production. Therefore, energy prices should remain well bid. Tactically, crude oil prices and Energy stocks are subject to pullbacks or consolidations after the run higher if a ceasefire develops. Nevertheless, we favor an Overweight position in the Energy sector for the intermediate term.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	27.8%	Premium relative valuations, high betas, and rotation from growth to value influence our Equal Weight position in Technology. Despite our market weight position, Technology remains the largest weighting in the S&P 500 and thus an important contributor to portfolio returns. For this reason, stock picking is paramount. With earnings revisions still trending higher, stock-picking opportunities are plentiful (we recommend sticking with the highest quality names).
	CONSUMER DISCRETIONARY	12.1%	Higher crude oil and gasoline prices, up 50% and >60% respectively over the past 12 months, will eat into discretionary incomes. Even if the Russia/Ukraine war ends quickly, energy prices will likely maintain a risk premium given the Russian aggression. Earnings forecasts call for impressive growth of over 20% for 2022 and 2023. However, revision trends are falling for 2022, especially for Q1 and Q2. If energy prices remains stubbornly high, earnings in the back half of the year are also susceptible to downward pressure. We see select opportunities among the companies benefiting from the reopening of the global economy. However, with the largest weightings in the sector beneficiaries of the pandemic conditions, the overall index may struggle as investors rotate to reopening plays.

	SECTOR	S&P WEIGHT	COMMENTARY
EQUAL WEIGHT	COMMUNICATION SERVICES	9.4%	We finally succumbed to weak earnings revision trends and falling relative price strength and lowered our rating. Weak relative price strength coincides with a downward sloping earnings revision trend over the past five months. A general market rotation away from growth stocks with interest rates ticking higher is another trend we will not fight for now. From a tactical standpoint, there are signs of opportunity at the stock level instead of the cap-weighted index level.
	MATERIALS	2.6%	The sector has been a solid performer (and potential upgrade) with the Russia/Ukraine conflict pushing already elevated commodity prices higher. However, we remain Equal Weight. The largest weighted subsector, chemicals, may not generate the margins investors require as rising energy prices raise input costs.
	REAL ESTATE	2.6%	Real Estate relative strength has held up well, at roughly the midpoint of its range over the past seven months. Hard assets, such as real estate, become more favorable in inflationary environments, though relative valuation is reaching the higher end of a multi-year range. We also view the potential for higher rates as a headwind to relative performance.
UNDERWEIGHT	CONSUMER STAPLES	6.0%	We remain Underweight Consumer Staples despite our belief that the equity market will remain sloppy over the near term. Once the dust settles, higher input costs may restrain margins as many Consumer Staples industries have less pricing power than others. In addition, valuations are less attractive due to recent outperformance by the sector, further influencing our Underweight position. Finally, our upgrade of Health Care, a sector we feel offers more favorable longer-term fundamentals than Consumer Staples, is our 'defensive' portfolio move for the current uncertain market.
	UTILITIES	2.6%	Negative earnings revision trends and potential underperformance if interest rates trend slightly higher keep us on the sidelines for this defensive sector.

DISCLOSURES

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

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

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

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

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

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

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

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

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

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

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

The process of rebalancing may result in tax consequences.

The Bloomberg Barclays Intermediate US Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the US Aggregate Index with less than 10 years to maturity. The index includes investment grade, US dollar-denominated, fixed-rate treasuries, government-related and corporate securities.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The BofA Merrill Lynch Core Fixed Rate Preferred Securities Index is designed to replicate the total return of a diversified group of investment-grade preferred securities.

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 Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market.

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