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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

A Time For Finesse

Are you ready for some football? Not American football, but European football—otherwise known as soccer! For the five billion spectators awaiting the start of the 2022 World Cup in Qatar this November, the sport is the epitome of speed and agility. But for the players on the 32 participating teams, it is so much more. The deceptively simple-seeming game requires years of training. It goes beyond the fundamentals of ball handling to field awareness, anticipation, and making the right decisions under duress quickly. It is knowing when to dribble or pass, press or contain, and shoot with power or finesse.

Like soccer fans following their favorite players (let's go Christian Pulisic!), investors have no small amount of anticipation, if not angst, about every move central banks are making on the global economic playing field. In this intense time of soaring inflation and interest rates, what is the Federal Reserve's (Fed's) *game plan*? How aggressive will it be? Can it dribble cautiously downfield, carefully containing rising prices, or will it push a power offense that *kicks* the economy into a punishing recession? As the markets recalibrate expectations and evaluate the plethora of risks on the field, this is a high-pressure time that requires finesse.

This fall, all eyes will be on the perennial superstar, the Fed, as it pursues its goal of winning against inflation. In the World Cup, the top scorer gets the coveted *Golden Boot* award. If there was an award for tallying interest rate hikes, the Fed would definitely be in contention this year. But for many investors, the goals are slightly different: to control inflation *and* keep the economy growing—in other words, a more delicately balanced offense that requires finesse and a sense of the economy's field position.

By raising rates into restrictive territory (>2.75%) to cool inflation, the Fed may have put the economy *offside*—if not actually scored against itself. Rapid-fire, heavy interest rate hikes may not exactly be a winning strategy. In soccer terms, the Fed's fancy footwork may end up tripping the economic expansion. The further the Fed raises interest rates above 4% (our forecast is 4.5%), the greater the probability of a recession. As a result, our *official call* is for the US economy to experience a mild recession starting early next year (2023 GDP forecast: -0.5%). Also, we're *issuing three yellow cards* (or warnings for potential downside risk) for a lackluster housing market, elevated energy prices, and weak consumer sentiment.

A balanced *defense* is imperative in the World Cup—and in managing portfolios, too. Yet there have been few investments that have not been *penalized* as both the bond and equity markets have been sidelined with painful losses. In fact, the correlation of bonds to equities is the highest we have seen in nearly 25 years. Going forward, however, bonds ought to provide some defensive buffer if yields fall amid a struggling economy. Importantly, yields are attractive for the first time in years as the 10-year Treasury yield nears ~4%. Our view is that it will ease from this peak (year-end 2022: 3.25% and year-end 2023: 3.00%) as the economy slows and inflation abates. Note that Treasury yields historically tend to peak near the end of the Fed's tightening cycle. High quality Treasury securities and municipal bonds remain compelling, but the inverted yield curve and the potential of a recession place riskier high yield bonds and emerging market bonds *out of bounds*.

We are approaching halftime in President Biden's term, with midterm elections just around the corner. At this point, we expect Congress will be split. The Republicans seem likely to take control of the House due to the historical precedent of the incumbent party losing seats; current polls suggest they just need to *ride out the clock*. On the other hand, polls slightly favor the Democrats retaining control of the Senate in what appears to be another *nail biter*. With gridlock on Capitol Hill, the Biden Presidency will become a *game of two halves* as major *game changing* legislation is unlikely to be passed. If so, political policy risk (specifically the potential for increased taxes) will be reduced until the next election cycle.

The equity crowd has been hushed, stunned as stocks have succumbed to a bear market (a decline of more than 20%). Significant *injuries* have hampered the markets—rising inflation, higher interest rates, a stronger dollar, and tumbling earnings growth revisions. But those plays are likely already priced into the market and the volume of the equities' *vuvuzela* (traditional World Cup noisemakers) may soon increase—rallying a turnaround. A *hat trick* of

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three factors could lead to a rebound in equities. First, in the upcoming third quarter earnings season, better-than-feared earnings could spark a rally, as they did in the second quarter. Second, inflation deceleration could halt further Fed rate hikes. Finally, midterm elections have historically had an impact themselves, regardless of the outcome. In fact, in the last 19 midterm elections, the S&P 500 has been positive every time 12 months after the elections (up, on average, ~14%). Even if a mild recession ensues, we should be beyond it by the end of next year and the equity market tends to be forward-looking. That's why we expect the S&P 500 to reach ~4,400 by year-end 2023. From a sector perspective, there is no need for *substitutions*, as Energy, Health Care, and Financials remain our favorites. If you're looking for a *Best Young Player* to add value to your portfolio longer term, consider recruiting small-cap stocks, featuring an attractive 30% discount relative to the S&P 500.

World Cup soccer fields take a beating over the 28-day tournament, so selection of the type of grass is very important. Where does the seed for it come from? Surprisingly, the US! Just as US seed provides the most resilient grass, the US economy and equity markets retain their durable investment advantages. Consider Europe, facing a huge *penalty kick*—an energy crisis as the coldest months approach. There, policymakers are also juggling the need for additional fiscal stimulus—the root of the recent inflationary surge—to help cash-strapped consumers with the need for higher interest rates to fight ongoing inflation. The inflationary impact of the stronger dollar on European imports and energy commodities priced in dollars only complicates the task of policymakers. While the odds for winning this year's World Cup favor both France and England, their precarious economic conditions lead us to pick the US when it comes to our preferred equity region.

The World Cup can be full of surprises—good and bad for fans. Until inflation abates and Fed policy clarifies, market volatility is likely to continue. But to borrow a saying from Croatian soccer superstar Ivan Rakitic, "The smartest thing I did is I never gave up." Despite some of the setbacks we've experienced this year, we encourage investors to remain engaged and not *watch from the sidelines*. Patience and sticking with your game plan can be critical to success, and selectivity will be key. Diversification, asset allocation, and a long-term mindset are timeless yet critical skills for any investor. And while this year's performance in most major asset classes has been disappointing, everyone loves a comeback!

The upcoming quarter will move quickly—from the changing colors of the leaves to Election Day to the holiday season that follows. We wish you and your family health and prosperity in the final months of 2022. Go U-S-A! Bring home the FIFA World Cup Trophy for the first time ever! Enjoy the games!

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Economic Outlook: The Fed's Conundrum

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

The Fed and the market are going to have a tough time during the last quarter of the year with the economy showing no signs of slowing down. The strength of the employment recovery after the COVID-19 pandemic ended has continued unabated and has been the reason why we still contend that the US economy did not experience a recession during the first half of 2022, even though GDP numbers showed two consecutive negative prints. And this strength continued during the first two months of the third quarter of the year with employment growing by 526,000 in July and by another 315,000 in August.

In fact, some economists are calling the current environment, or the path that the Fed should follow in the coming quarters, a 'growth recession.' That is, an economy growing very slowly but shedding jobs along the way, so wage pressures start to recede and help push inflation back to the 2% for the personal consumption expenditures deflator the Fed has established as its inflation target.

> An increase in the labor force participation rate would be a best-case scenario for both the Fed and the markets, as the rate of unemployment would increase, reducing pressures from higher wages on inflation which, today, is at the top of Fed officials' concerns.

TO RAISE OR NOT TO RAISE

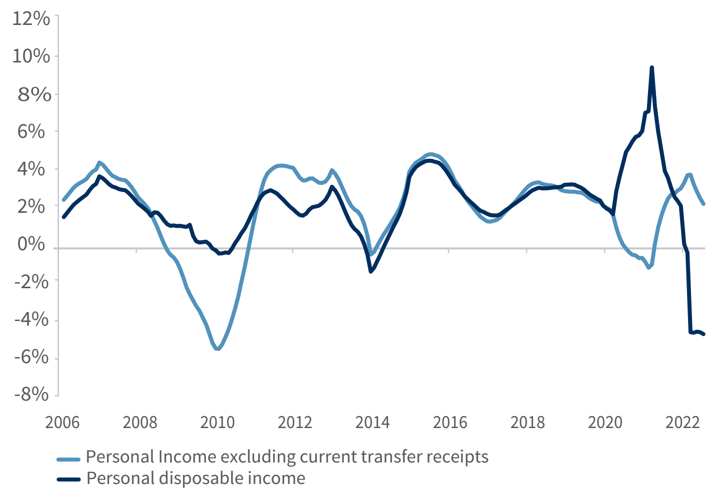
However, there isn't a unique path to this new scenario. Certainly, the preferred path for the Fed is one it has some relative control over. That is, to continue to increase interest rates until the economy falls into a recession. The second path, however, is to have patience and allow the current increase in rates, plus the ones baked into market expectations for the rest of the year, to do their job. However, for this strategy to be successful, it will need help from the labor force participation rate, or something like what we saw in the August jobs report.

The August jobs report saw employment up by a very strong 315,000. However, this number of jobs was much weaker than in July, when employment surged by 526,000. Strength in employment in August was broad based, according to the establishment survey of employment. Even retail trade employment was very strong in August after several months of relatively weak numbers and speculation of large inventory accumulation weighing down the sector over the summer months. Furthermore, construction employment was very strong, up 44,000 in August, even though the sector has seen its share of weakening because of higher mortgage interest rates. However, there has been a pickup in public construction activity that seems to be helping the employment side of the construction market even though public construction is only about 20% of total construction spending in the US economy.

But the most important detail of the August employment number was the increase in the labor force participation rate, which pushed the rate of unemployment from 3.5% in July to 3.7% in August. This was the result of a 786,000 increase in the civilian labor force after several months of decline.

Personal Income & Personal Disposable Income

(% change, 12-month moving average)



Source: FactSet, as of 9/20/2022

BEST CASE

An increase in the labor force participation rate would be a best-case scenario for both the Fed and the markets, as the rate of unemployment would increase, reducing pressures from higher wages on inflation which, today, is at the top of Fed officials' concerns. But wishing for this strategy to work its magic is close to asking for a fairy-tale ending for this highly unusual business cycle.

Thus, the risk is that the Fed overplays its hand and increases the federal funds rate more than what would be necessary to bring inflation down if it had more time.

If we look at incomes (see graph at top right), real personal disposable income is declining due to the aftereffects of the large fiscal effort made during the COVID-19 pandemic. However, a closer look at the composition of income shows that although personal disposable income is declining, personal income excluding transfer receipts is still increasing, albeit at a much lower rate than before because of higher prices.* This could indicate that the Fed may have some more work ahead in terms of slowing down the economy.

But the Fed will have to be careful as we also expect consumption to continue to slow down in the coming quarters as incomes continue to deteriorate. As we have been pointing out over the last several months, real wages and salaries, as measured by the employment cost index, have been coming down due to the increase in inflation (see graph at right). This means that it is expected that consumption will continue to slow in the coming quarters, helping to moderate inflation in the future.

Furthermore, what the graph below shows is that the US economy can generate higher real wages and salaries (i.e., from 2015 until early 2020) without triggering higher inflation. Perhaps the biggest issue today for the Fed is whether we will go back to a pre-pandemic economic environment in which inflation is an afterthought; or whether inflation is going to persist once the special conditions

Real Wages and Salaries

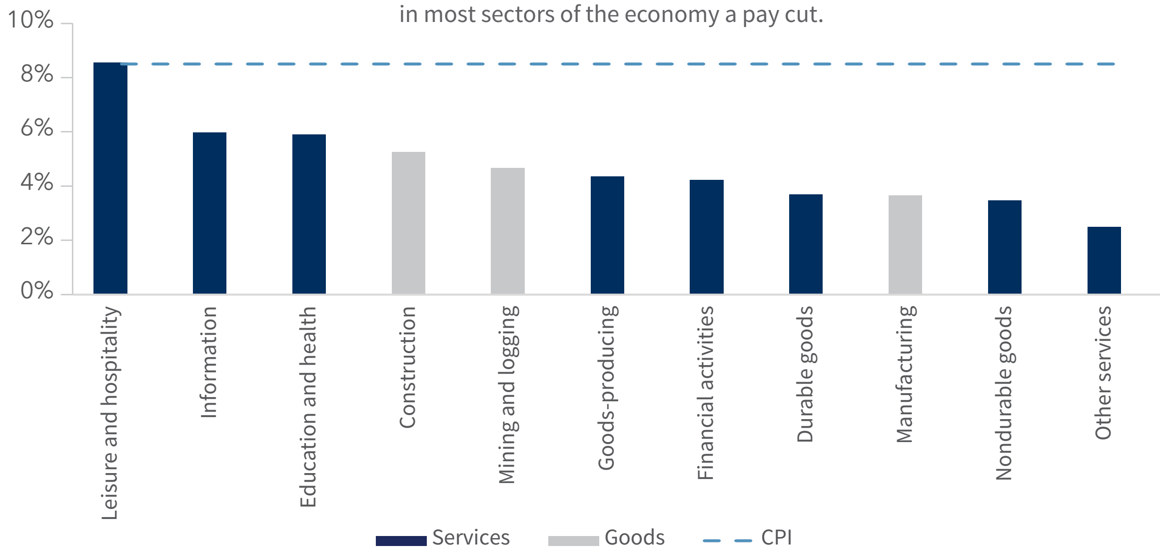
Inflation has almost taken away all the gains workers accrued over the last eight years or so in terms of purchasing power of wages.

Source: FactSet, as of 9/20/2022

*Transfer Receipts: Transfer receipts are benefits received by persons for which no current services are performed. They are payments by government and business to individuals and non-profit institutions.

Sector Wages and Inflation

Despite higher wages, the impact of inflation gave workers in most sectors of the economy a pay cut.



Source: FactSet, as of 9/20/2022

created by the pandemic are finally out of the system.

As we have written in the past, reforming our immigration system will also be of great help in moving both the rate of unemployment and the labor force participation rate higher because the pool of available workers will increase. This is especially true for the service sector, specifically for the leisure and hospitality sector of employment, which has seen the largest increases in nominal wages and salaries during the last year or so. This should help reduce the pressure over wages, which is one of the reasons why inflation has remained higher for a longer period.

BOTTOM LINE

These issues are not small and are very difficult for only one institution like the Fed to tackle, because some of them are not within its sphere of influence. However, the way in which these issues are solved will ultimately determine how high the Fed must go in terms of interest rates, and for how long as well as how deep a recession will be needed to tamp down the inflation monster. We believe that the US economy could go back to pre-pandemic conditions with lower rates of inflation once all the supply conditions come back to more normal levels.

KEY TAKEAWAYS:

- The Fed and the market are going to have a tough time during the last quarter of the year with the economy showing no signs of slowing down.
- The most important detail of the August employment number was the increase in the labor force participation rate, which pushed the rate of unemployment from 3.5% in July to 3.7% in August.
- The best-case scenario, for both the Fed and the markets, is for the labor force participation rate to continue to go up so unemployment continues to increase. An increase in the labor force participation rate will help reduce the pressure from higher wages on inflation which, today, seems to be at the top of Fed officials' concerns.
- The risk is that the Fed overplays its hand and increases the federal funds rate more than what would be necessary to bring inflation down.
- We believe that the US economy could go back to pre-pandemic conditions with lower rates of inflation once all the supply conditions come back to more normal levels.

Deglobalization: A Double-Edged Sword

Giampiero Fuentes, CFP®, *Economist,* Raymond James

Globalization has accelerated the world's economic growth, furthered by technological and transportation advances that allowed the integration of international markets. Since 1950, the world's trade volume has increased by 40 times, reaching a record value of $28.5 trillion in 2021. A key component that makes all this possible is robust and complex supply chains that allow goods produced by a country to be transported elsewhere in the world. However, trade as a percentage of world gross domestic product (GDP), has been declining since the Great Recession. In fact, over the last few years, these global supply chains have faced a variety of headwinds, ranging from economic nationalism, a pandemic-induced shutdown, and most recently, a major geopolitical conflict.

The relatively mild consequences of the tariffs imposed by President Trump on China in 2018 were just a tiny sample of the shambles brought by the COVID-19 pandemic to what seemed to be a perfectly efficient working model of supply chains. In fact, the volume of world trade declined by almost 20% in a matter of months, causing a collapse of a similar magnitude to that of the Great Recession. This year's war between Russia and Ukraine only widened the cracks, exposing the world to just how much nations truly rely on one another for basic needs, with energy prices spiking to the highest level since 2008, and food shortage concerns being top of mind for many countries.

> Globalization has allowed developing countries to grow faster, increase their living standards, and lifted millions of people out of poverty. Developed economies have enjoyed lower inflation for decades, as companies benefitted from outsourcing production to areas with lower costs of materials and labor.

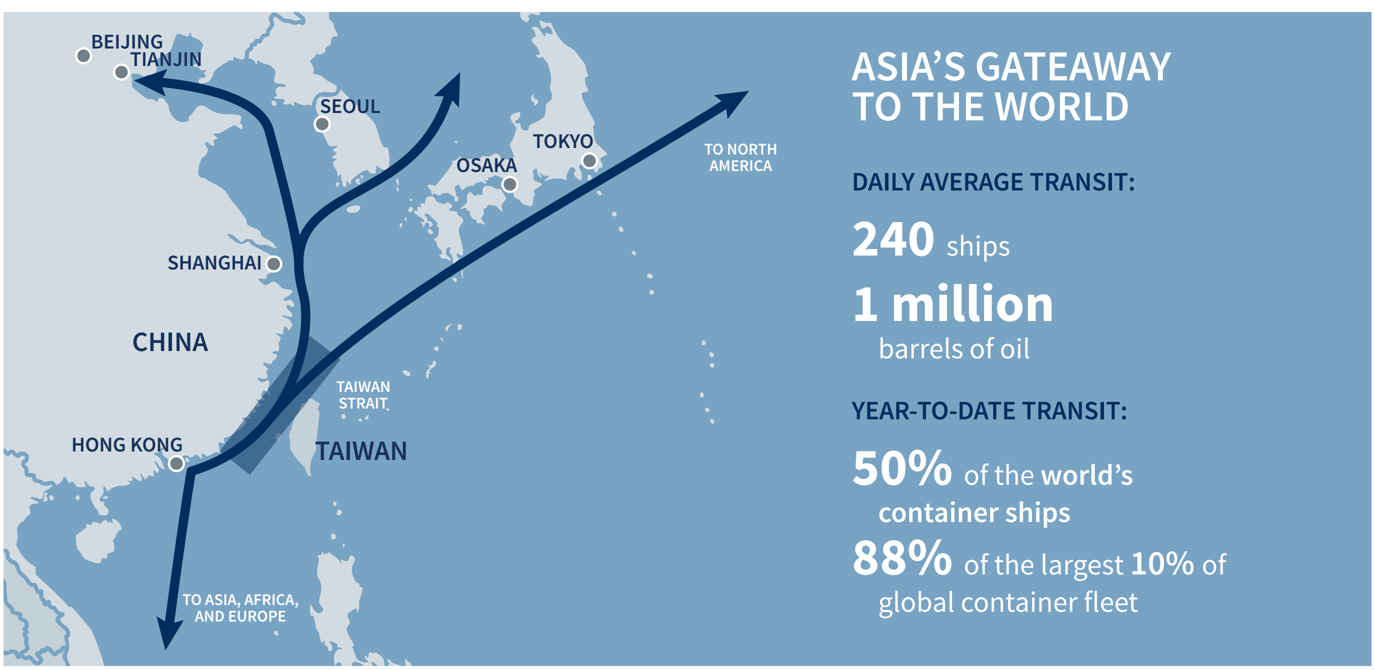
Whether it's a pandemic, a war, or any other unpredictable event, they're likely to have severe consequences, and the world could potentially be hit by another black swan event at any point. However, there is a common denominator among these events, and that is the interdependence among countries that years of globalization has brought to the world. Unquestionably, globalization has allowed developing countries to grow faster, increase their living standards, and has lifted millions of people out of poverty. Developed economies have enjoyed lower inflation for decades, as companies benefitted from outsourcing production to areas with lower costs of materials and labor. However, the events mentioned above could start pushing nations and companies to begin to prioritize security over efficiency and lower costs.

Source: FactSet, as of 9/20/2022

THE FOURTH TAIWAN STRAIT CRISIS

Natural disasters, cyberattacks, or simple accidents are daily occurrences that can temporarily disrupt supply chains. However, the potential of a long-lasting conflict between Taiwan and China could become a cataclysmic supply chain disruption. Taiwan is only just bigger than the state of Maryland, and it contributes ~1% to global GDP. So, how can a country so small, that contributes so little to global GDP, be so important to China, the US, and the world economy? Taiwan is renowned worldwide for its semiconductor industry, being responsible for manufacturing almost two-thirds of global microchips and over 90% of high-value integrated circuits. Essentially, most electronics we use every day have at least some components that were developed and manufactured in Taiwan. However, what's less known is the importance of its waterways for global trade, as one-third of the world's seaborne traffic passes through the Taiwan Strait. While there are alternative routes around the channel, the Taiwan Strait can be described as the gateway to access all the important ports in Northeast Asia.

From an economic standpoint, a blockage of the Taiwan Strait or Taiwanese airspace for an extended period of time would likely result in worse consequences than what the world experienced during the COVID-19 pandemic in terms of supply chain disruptions. Additionally, due to its small size, it is fair to assume that if attacked, Taiwan would at least reduce the production and export of goods



Source: Bloomberg, as of 9/2022

S&P 500 Companies Mentioning 'Offshoring' During Earnings or Conference Calls

Source: FactSet, as of 9/20/2022

during an ongoing conflict, and if factories were to be damaged, it could take a very long time for them to come back online. This is not to say that a war between these two nations is about to erupt, as we believe it's in neither country's best interest. However, we saw how quickly the situation precipitated in Europe earlier this year, and that's why investors need to be prepared for all sorts of outcomes.

A potential conflict between Taiwan and China, and the probable involvement of other global superpowers, would have all sorts of negative consequences, and its repercussions would likely be felt for years if not decades. In addition to the countless lives that could be lost, a conflict of this size and scope could have tremendous inflationary impacts worldwide, as costs would soar, and profit margins would be squeezed. The US is the largest importer of goods, of which approximately one-fifth comes from China, and while the US will likely be able to shift its trading needs to other countries, the impact of this transition would be substantial. In fact, this process will take time, and, in simple economic terms, the now limited competition will ultimately lead to higher prices.

MADE IN AMERICA

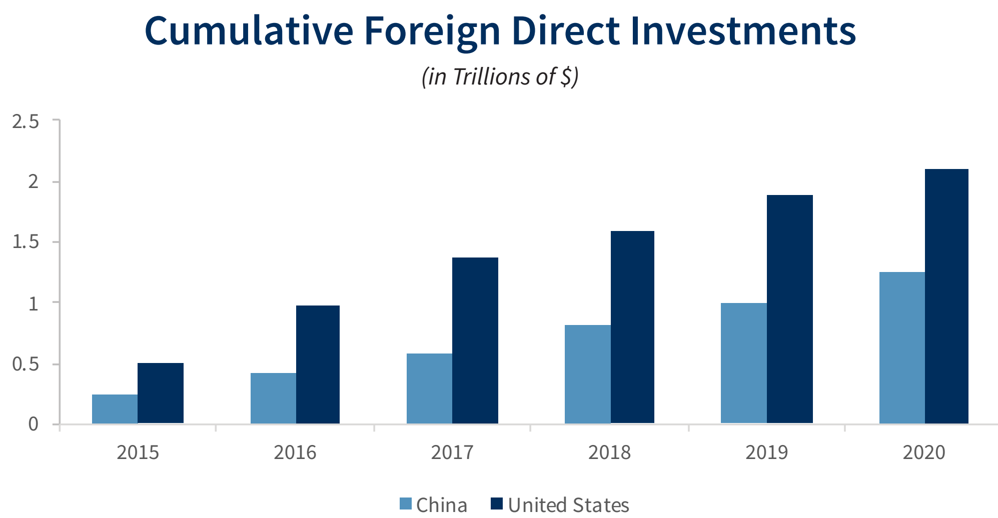
With two massively disrupting events in just over two years and the potential for a multitude of unpredictable events brewing in the future, nations are starting to consider options to mitigate future potential supply chain disruptions. The goal is to regain control over the end-to-end supply chain by reducing exposure to external risks, which would otherwise not be present if the manufacturing process wasn't outsourced. The issue is not new, as only ~30% of companies in the S&P 500 are discussing 'offshoring' in their earnings transcripts and conference calls, compared to over 75% of them only a decade ago.

Reshoring

The practice of transferring a business operation that was moved overseas back to the country from which it was originally relocated.

PROS:	CONS:
CONTROL OF SUPPLY CHAIN	LACK OF SKILLED LABOR
REDUCED LEAD TIMES (less distance traveled)	LABOR COST
FEWER IMPORT TARIFFS	RESOURCE SCARCITY
LOCAL JOB CREATION	INITIAL INVESTMENT REQUIRED
	HIGHER COST

Source: Raymond James Investment Strategy



Source: FactSet, as of 9/20/2022

Governments have started to offer incentives to reshore production and prevent future disruptions. For instance, to move away from its reliance on Taiwanese-made semiconductors, the US has announced the CHIPS and Science Act, which includes a $52 billion package aimed at incentivizing US production of semiconductor chips. Reshoring certainly has its perks, but it also comes with an array of cons.

Outsourcing manufacturing has worked for decades, and it has allowed companies to be more cost effective and boost profit margins while keeping products affordable for clients. This economic interconnectedness has allowed developed nations to take advantage of emerging economies' lower cost of labor, and emerging economies have benefited from an inflow of foreign investments. Additionally, the US has benefitted for a long time from foreign direct investments, such as foreign car manufacturers' building plants in the United States. While this number is very volatile on a yearly basis, the US has received over $2 trillion in foreign direct investments in the last five years alone, and this number does not account for all the indirect positive effects on the US economy. Similarly, China, which has arguably been the country that has benefitted the most from globalization since the 1990s, has also received over $1 trillion in foreign direct investments over the last five years. This is to reiterate that it's not in either country's interest to lose such a large inflow of investments in their respective economies.

BOTTOM LINE

While inflation is expected to come down in the near term, the economic consequences of either another geopolitical conflict or the rise of deglobalization could be an issue going forward. Unfortunately, there isn't a one-size-fits-all solution to fix global supply chains, but some companies with a longer-term strategy are attempting to expand their supplier base to spread the risk despite adding layers of complexity to their supply chains. However, in the case of a global economic shutdown like we witnessed in 2020, this solution would still not make a difference. Globalization is both a blessing and a curse, one from which a developed economy such as the US reaps more benefits than not. However, just as successful investors diversify their portfolios through asset allocation to maximize returns for a given level of risk, companies and nations should aim to find a balance between complexity and security.

KEY TAKEAWAYS:

- Complex and robust supply chains were a key component in the development of globalization.
- Over the last few years global supply chains have faced a variety of headwinds, ranging from economic nationalism, a pandemic-induced shutdown, and most recently, a major geopolitical conflict.
- The Russia-Ukraine war has shown the world just how interdependent we are and has increased awareness of the dangers of that interconnectedness.
- Globalization is both a blessing and a curse, one from which a developed economy such as the US reaps more benefits than not.

The State of the Midterm Elections: Red Wave or Blue Wall?

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

The political set up at the beginning of 2022 carried significant warning signs for Democrats with a political prognosis that a 'Red Wave' is coming, favoring the election of Republicans. Democrats, now holding the White House and both houses of Congress (five seats in the House and tied in the Senate), are not only battling history (the party controlling the White House has lost an average of 23 seats in the midterms over the last 40 years), but they are also battling a macro environment that traditionally is a political albatross for the party in power.

Polling shows near record levels of dissatisfaction with the direction of the country among voters, historically low approval ratings for President Biden, and inflation concerns are dominating headlines. Looking at the data, voters' minds regarding midterm elections have traditionally been effectively made up around the spring of a midterm election year. In fact, presidential approval has not been shown to materially improve in the past 40 years from the spring into the fall of a midterm election.

However, while there are still significant structural factors that favor Republican candidates in this midterm cycle, we are seeing signals that the floor is rising in terms of expected Democratic performance that could present an unexpected 'Blue Wall' of resistance for Republicans' chances of significantly altering control of Washington. Recent electoral surprises favoring Democrats in Kansas, New York, and Alaska highlight that the race is more fluid than many had expected at the start of this year. The traditional voter enthusiasm behind challengers is in part being matched by voters responding to the recent Supreme Court decision in Dobbs v. Jackson Women's Health Organization. Additional factors motivating Democratic voters and Democratic-leaning independents include a string of high-profile legislative victories, including domestic technology manufacturing incentives and a finalized reconciliation bill that directs new funding toward clean energy production and extends healthcare coverage for many Americans. Further, the announcement of action on student debt relief will also be weighed as a

> While we continue to expect that Democrats are likely to lose the House, prospects for Democrats retaining the Senate have materially improved into the fall.

motivating factor for younger voters. In all, while we continue to expect that Democrats are likely to lose the House (and with it, their Congressional majority), prospects for Democrats retaining the Senate have materially improved into the fall. This will have important market impact in terms of the Biden administration's regulatory agenda and confirmation ability for key posts if Democrats ultimately maintain or expand their Senate majority.

A LOOK AT THE RACE FOR THE HOUSE

The clearest opportunity for a change in power in Congress rests with control of the House of Representatives. Democrats are currently holding onto a slim five seat majority in an environment that favors challengers following the 2020 redistricting process and notable tailwinds behind Republican candidates. The magic number for a House majority is 218 seats. Looking at a seat-by-seat analysis, Republicans are currently favored in at least 213 Congressional districts (seats rated as solid, likely, or lean Republican) and Democrats are favored in 190. The battle for the majority will likely be decided by the 32 remaining 'toss-up' seats. Of these 32 seats, 24 are currently held by Democrats and 8 by Republicans. Republicans flipping just 5 of the 24 Democratic-held seats flips control of the chamber. Supporting Republican tailwinds and expectations for significant wins, retirements among Democratic lawmakers in this cycle have hit a recent historical high, and Republicans are seeing the most candidates running for seats compared to recent cycles. Both metrics often correlate with a change in control of the House.

With expectations high for a Republican victory in the House, it is worth asking what factors could limit the Red Wave potential. Given the national political setup, some may be expecting an expansive Republican victory along the lines of recent 'wave' elections that saw the party in power lose 42 seats in 2018 and 64 seats in 2010. Those elections were proceeded by an election where the party that won the majority outperformed and picked up the marginal seats, providing easy targets to the opposite party the following election. The opposite happened in 2020, when Republicans delivered an unprecedented result of winning 100% of the seats rated 'toss-up' (plus several rated lean Democratic/likely Democratic) but fell short of winning the majority. The Republican 'outperformance' in 2020 could cap the ceiling in terms of seats Republicans can win this fall. Conversely, for Democrats to win, they would have to deliver another 'unprecedented' sweep of the seats rated 'toss-up.'

Our base case remains that the House is likely to flip toward Republicans, but the margin of victory may be smaller than anticipated, which may impact legislation that the House is ultimately able to pass with a smaller Republican majority in 2023-2024.

Presidential Approval and Midterm Results

Biden fighting history to improve approval rating and limit midterm losses

In cycles where a president's approval is below 50%, significant House and Senate seat losses have occurred since 2006 (the 2018 Senate race being an exception, where Republicans picked up two seats).

Year	President	Approval: August	Approval: November	House Outcome	Senate Outcome	Control of Congress
1982	Ronald Reagan	41%	43%	-26	+1	Status Quo: Split Congress
1986	Ronald Reagan	62%	63%	-5	-8	Democratic Congress
1990	George H.W. Bush	74%	58%	-8	-1	Status Quo: Democratic Congress
1994	Bill Clinton	39%	46%	-54	-8	Republican Congress
1998	Bill Clinton	64%	59%	+5	0	Status Quo: Republican Congress
2002	George W. Bush	68%	63%	+8	+1	Republican Congress
2006	George W. Bush	37%	40%	-31	-6	Democratic Congress
2010	Barack Obama	45%	45%	-64	-6	Split Congress
2014	Barack Obama	41%	40%	-13	-9	Republican Congress
2018	Donald Trump	41%	40%	-42	+2	Split Congress
2022	Joe Biden	44%	**TBD**	**TBD**	**TBD**	**TBD**

Source: Raymond James Equity Research, Gallup "Presidential Job Approval Center" data

THE BATTLE FOR THE SENATE

Political support for the Biden administration's regulatory agenda and the ability of the White House to confirm selections to top government posts (including the Supreme Court) will rest with control of the Senate. As such, we are likely to see significant financial resources and political capital devoted to the key Senate races, which we currently view to be Arizona, Georgia, New Hampshire, Nevada (current Democratic-controlled seats); and North Carolina, Pennsylvania, and Wisconsin (current Republican-controlled seats). Reach seats include Florida (Republican incumbent) and Colorado (Democratic incumbent).

Looking at the seats Democrats are defending, Democratic incumbents currently have both the funding and polling advantage across AZ, GA, NV, and NH. However, the 2020 Senate race showed that these metrics should be viewed with some skepticism in terms of their predictive power. Particularly, 2020 polls significantly underestimated Republican candidates, who saw surprising overperformance in final votes. On average, final vote totals saw an almost six percentage-point variance in favor of Republican candidates when compared to polls, with some individual results swinging as much as 14 points compared to polling averages.

The optimistic case for Democrats retaining or even expanding their Senate majority rests on the following: backlash to the Supreme Court's Dobbs decision, a roster of untested/unconventional challengers in key races, and the historical consistency of states' preferences between presidential and Senate elections serving as tailwinds for Democrats in the race for the Senate. We have also observed a trend of Senate candidates significantly overperforming the national approval rating of incumbent presidents of the same party, which limits the potential drag of an unpopular presidency on the prospects of Democrats retaining control of the Senate.

Diving deeper into these factors, we see the potential impact of the Dobbs decision rippling through the key Senate races of AZ, GA, NC, PA, and WI in terms of voter turnout, enthusiasm, and support from Democratic-leaning independent voters. While these states do not have high-profile ballot initiatives similar to Kansas, the down-ballot state-level policy impact may influence voter behavior. The Republican nominees in some of these key races (particularly AZ, GA, and PA) are first-time candidates, which has proven risky in past high-profile elections with the possibility of gaffes and missteps in the final stretch. We have also observed a trend of states maintaining consistent party preference across presidential and midterm Senate races. Going back to 2008, only once has an incumbent of the president's party running for reelection lost in the midterms in a state that voted for the president's party in the previous election cycle. If this trend holds, states that voted for Biden in 2020 with current Democratic incumbents (AZ, GA, NV) could see Democratic victories that maintain the 50-50 Senate split. In this case, PA and WI could offer Democrats pickup opportunities, as both states voted for President Biden in 2020 and are currently seats held by Republicans. Overall, the Senate should be viewed as a true battleground this fall, with prospects for control of the Senate likely coming down to individual race factors rather than serving as a referendum on the direction of the country.

Several Tailwinds at Notable Levels that Favor GOP

Multiple tailwinds, such as *inflation*, *presidential approval, confidence in Congress*, *consumer sentiment*, and *dissatisfaction with the direction of the US* are at their highest/lowest levels at this point in time compared to previous recent midterms in ways that *favor the Republican Party*.

WITHIN THE LAST 40 YEARS:

Inflation	in July of a midterm year is at its **highest (8.5%)**
Presidential Approval	around July of a midterm year is at its **lowest (38%)** (*and presidential approval is even lower in many contested areas*)
Confidence in Congress	during a midterm year is **tied with 2014 for the lowest (7%)**
Index of Consumer Sentiment	in June of a midterm year is at its **lowest (50)**
Dissatisfaction with the US	around June of a midterm year is at its **highest (87%)**

Source: FactSet, as of 9/20/2022

IN SUMMARY, REPUBLICANS SEE FAVORABLE NATIONAL ENVIRONMENT, BUT DON'T DISCOUNT DEMS

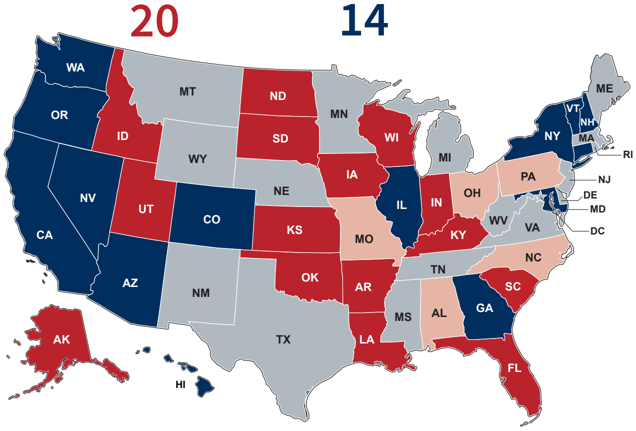
The overall trend in national political factors has been one of a Democratic recovery relative to the national environment seen earlier this year. The increased prominence of social issues, sustained labor market recovery, and the potential peak of inflation (if the downward trend in domestic energy prices holds) alleviate some of the pressure that has capped Democrats' prospects. While we continue to see material Republican gains (most likely in the House), the likelihood is growing that the earlier forecasted 'Red Wave' is dampened by a reinforced 'Blue Wall,' particularly when it comes to improved chances for Democrats to hold the Senate. In effect, the result of a split Congress following the midterm elections may be the Goldilocks outcome for markets. With this setup, any further threat of significant tax adjustments will be off the table until 2025. Headline risk on budget/debt ceiling battles will also be less of a factor, as these fights are likely to stay within Congress and be resolved, rather than pit a unified Republican Congress against a Democratic White House.

While we view a scenario of Democrats controlling both the House and Senate in 2023 as the possibility with the lowest odds, this would also be the scenario that would drive an outsized market reaction. Legislative risk driven by tax increases as part of the Democratic reconciliation and social policy agenda is now largely viewed as a nonfactor by the market given the current political setup but would be poised for a resurgence on the off chance that Democrats overperform and maintain control of both chambers of Congress. We caution that the electoral landscape will continue to be fluid up until the election, and that recent cycles have shown that 'unprecedented' results cannot be fully discounted.

The Race for Senate

REPUBLICANS 20

DEMOCRATS 14



Republican Senate Seats
Open Seat - Current Republican
Democratic Senate Seats
Seats - Not Up For Election

BATTLEGROUND RACES

	DEM	GOP
AZ	Mark Kelly*	Blake Masters
GA	Raphael Warnock*	Herschel Walker
NH	Maggie Hassan*	Donald Bolduc
NV	Catherine Cortez Masto*	Adam Laxalt
NC	Cheri Beasley	Ted Budd
PA	John Fetterman	Mehmet Oz
WI	Mandela Barnes	Ron Johnson*

*Incumbent

Source: Raymond James Equity Research

KEY TAKEAWAYS:

- In the midterms, Democrats are battling history and an unfavorable macro environment.
- There are signs that the floor is rising in terms of expected Democratic performance that could present a 'Blue Wall' of resistance.
- Political support for the Biden Administration's regulatory agenda and the ability of the White House to confirm candidates for top government posts rests with control of the Senate.
- Dobbs decision impacts key Senate races in terms of turnout, enthusiasm, and support from Democratic-leaning independent voters.
- The result of a split Congress following the midterm elections may be the Goldilocks outcome for the markets.

Q&A: Dollar Dominance—Can It Continue?

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

The US dollar has been getting a lot of attention these days. This is not surprising given the greenback has gained over 17% against a basket of currencies this year to levels not seen in over 20 years.* While moves of this magnitude are not unprecedented, the dollar's steady climb is starting to have spillover effects on the rest of the world. This has implications for the economic performance of various regions and on the financial markets. Sanctions against Russia have also revived investor concerns about whether the dollar can maintain its role as the world's reserve currency. In this Q&A we delve into some of the more pressing questions on investors' minds.

Q: Why is the dollar so strong?

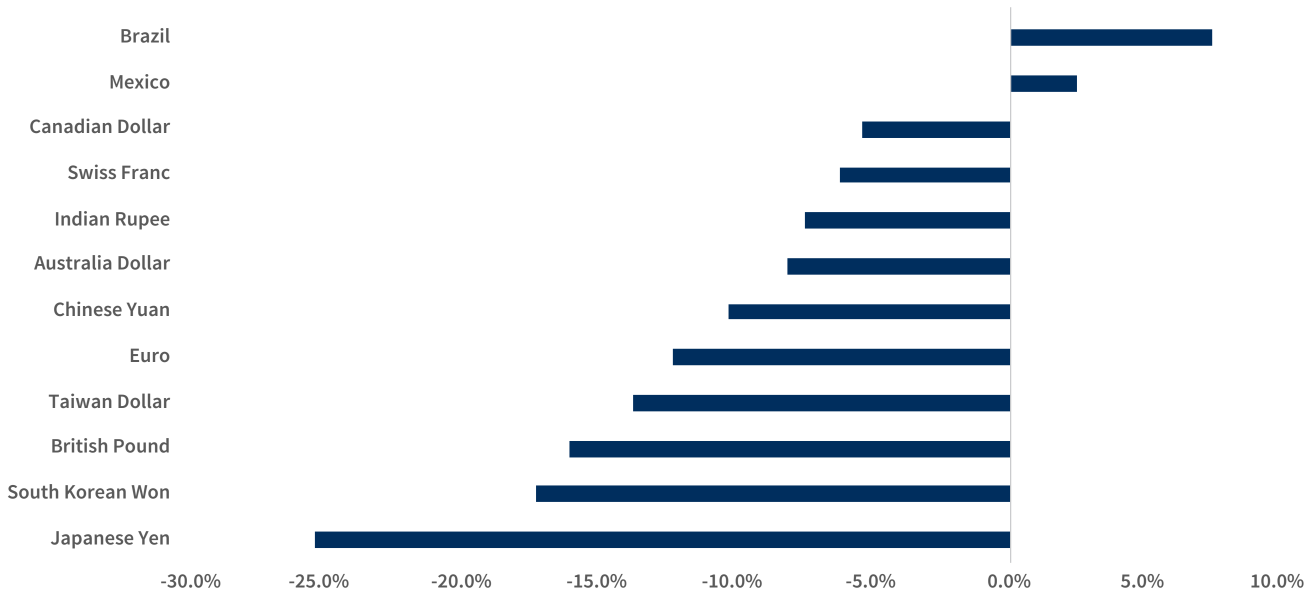
A: The surge in the dollar this year has primarily been driven by the hawkish Fed. With inflation running at a 40-year high, the Fed is in the midst of one of its most aggressive tightening cycles in decades—raising rates from near zero at the start of the year to between 3.0% and 3.25% by mid-September. Further rate hikes are expected for the remainder of this year. The Fed's policy stance has been the key factor driving the dollar higher, particularly as the Fed is on track to tighten more aggressively than other central banks. Higher relative interest rates are supportive for the US dollar. The challenging macroeconomic backdrop and uncertain geopolitical climate has also contributed to the ongoing strength of the US dollar. It is not surprising to see investors flock to dollar-denominated assets during periods of economic stress or elevated uncertainty as the US is considered a 'safe-haven.' With no end in sight for the Russia-Ukraine war, Europe on the brink of recession and China's zero-COVID policy stance still restraining Chinese economic growth, the dollar's strength seems likely to persist.

Q: What are the implications of a strong dollar?

A: Aside from the obvious—it's cheaper to take a vacation overseas—the US dollar plays an important role in the world economy. That is because it is the currency that powers global trade. The price of nearly every commodity contract traded in the world markets — from oil to copper to wheat — is priced in US dollars. Therefore, when the US dollar is strong relative to other foreign currencies, it drives up the cost of imported goods

*as of 9/23/2022

YTD Foreign Currency Returns against the US dollar



Source: FactSet, as of 9/20/2022

and feeds inflation directly into other economies. This is precisely what is happening today as the strong dollar is contributing to inflation pressures globally. While commodity prices tend to have an inverse correlation with the US dollar, this is not always the case. Commodity prices spiked after the war in Ukraine broke out and remained elevated as supply chain challenges persisted and weather-related issues impacted availability, at least until recently. This only compounds the challenges faced by the rest of the world. While the strong dollar has been problematic for others, it has been beneficial for the US economy as it holds down the price of imported goods and restrains domestic inflation. The dollar's strength can also pose a headwind for US companies that generate a significant portion of their revenue overseas. That's because their overseas earnings are reduced when they are translated back into US dollars. We've already seen some high-profile companies provide negative warnings during this past earnings season. This is definitely something to keep an eye on as third quarter earnings season approaches.

Q: Is the dollar's role as a reserve currency under threat?

A: When Western governments took the unprecedented step of freezing Russia's foreign exchange reserves after it invaded Ukraine this year, many started to wonder whether this would accelerate the displacement of the dollar as the world's preeminent reserve currency. The logic being that others would rapidly diversify their reserves away from the dollar to reduce the risk of their assets suffering the same fate. Speculation about the dollar's demise has been ongoing for decades, so these concerns are not new. But, despite these ominous predictions, the reality is there is no serious alternative to the US dollar. That is because the US dollar continues to be the most widely used currency in global financial transactions. It is also because the US Treasury market is the largest, most liquid and stable market in the world. And because of this, the US dollar continues to have the majority of the world's global reserves, which according to the International Monetary Fund, stand at around 59% today. While it is true that the dollar's share of global reserves has decreased over the last two decades, it still remains far above the next biggest market, the euro, which only accounts for around 20% of total reserves. Although there is speculation that China may have ambitions to dethrone the US dollar one day, we do not think it provides a serious threat. Less than 3% of the world's exchange reserves are held in Chinese yuan today. The reason for this is simple. It is because the yuan is still not a fully convertible currency, which means that its exchange rate is still strictly managed by the Chinese monetary authorities. So, for now, we do not think the dollar is at risk of being replaced as the world's reserve currency.

Economic Snapshot

EUGENIO ALEMÁN, PhD
Chief Economist

Although US economic activity has been decelerating for some time, the US labor market seems to be on a completely different path, and this has the financial markets on edge as they believe the Fed will be more prone to overdo its interest-rate hand than not. This has kept the markets on a roller coaster over the last several months as they try to decipher not only the next moves but also the size of coming rate hikes as well as the duration of high interest rates. It is clear the housing market has been the most affected by rates hikes, and now we are also seeing consumer demand weakening considerably due to higher inflation. However, an average of 400,000-plus new workers every month has kept the labor market humming as the service sector economy fully recovers from the pandemic. We see higher risks of recession for next year as the Fed continues to increase interest rates.

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	THE DOLLAR	Stronger. Central bank policy is a key factor in the near-term currency outlook and the Fed is likely to be more aggressive in tightening. The dollar has benefitted from global tensions, and it has surged for most of the year. While a strong currency lowers the cost of imported goods, it also negatively impacts overseas revenues.
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate.
	EMPLOYMENT	Nonfarm payrolls are still very strong. Expectations are for nonfarm payrolls to start to weaken while the unemployment rate increases.
	CONSUMER SPENDING	Consumer spending continues to weaken due to high inflation.
	BUSINESS INVESTMENT	Interest rates will continue to bite into the strength of business investment in the coming quarters.
	MANUFACTURING	Although manufacturing output has slowed down, export growth continues to be supportive of further expansion.
	LONG-TERM INTEREST RATES	Bond yields have increased considerably, and the yield curve has inverted further during the last several months.
	FISCAL POLICY	A reduction in fiscal stimulus (compared to the massive levels of 2020 and 2021) will weaken the contribution to GDP from government spending.
	REST OF THE WORLD	COVID-19 is still a factor globally. The war in Ukraine will have a bigger impact on Europe's economy than that of the US. Inflation is higher everywhere, which is an issue for emerging economies. Repeated droughts, floods, and other natural disasters continue to negatively impact crops, housing, and more.
UNFAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	There are important signs of slowing housing demand due to the strong increase in mortgage rates. We should continue to see weaker housing and lower home prices in the coming months.
	INFLATION	Elevated. Inflation remains the biggest risk for the economic outlook. The shift toward service consumption should help reduce price pressures on goods. However, oil prices remain the biggest threat to inflation.
	MONETARY POLICY	The Fed has become more aggressive with rate hikes and increased its ending fed funds rate target. 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:

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

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

Equal Weight: expect in-line relative performance

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

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

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	HEALTH CARE	14.7%	Health care remains a favored way to 'water down' portfolio volatility in the current environment. We remain Overweight given the sector's lower beta, attractive valuation, and long-term benefits of aging demographics, in conjunction with our expectations for back-and-forth trading for the broader market as the Fed hikes the fed funds rate within a slowing economic backdrop.
OVERWEIGHT	FINANCIALS	11.1%	The Financials have been hard-pressed to show sustainable outperformance, as the inverted yield curve and slowing global economy remain headwinds to performance. That said, valuation is inexpensive and bank balance sheets are very well capitalized, offering protection in weak economic scenarios and flexibility in more positive ones. We remain Overweight, and highlight the insurance subsector as performing relatively well given pricing power and a low beta.
OVERWEIGHT	ENERGY	4.6%	Despite slight downside in crude oil prices since June, the Energy sector continues its strong performance. We expect oil price volatility to be a key influence, but believe the strong fundamental backdrop is supportive. High oil prices and capital discipline continue to result in enormous cash flow generation. Valuation is also attractive with oil at current levels. We remain Overweight.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	26.6%	We believe that Technology will outperform on the other side of this bear market and would accumulate favored stocks in the pullback periods; however, for now, we maintain an Equal Weight stance overall. Long-term fundamentals are strong and valuation has become much more reasonable. But valuation is still above average, and rising real rates are acting as a headwind to those multiples (and performance) for now.
EQUAL WEIGHT	CONSUMER DISCRETIONARY	11.8%	High inflation is weighing on consumer disposable income and purchasing power, resulting in a challenging environment for Consumer Discretionary companies. Earnings estimates are being revised markedly lower, and we expect this trend to continue. That said, valuation is much more compelling at current levels, pricing in a lot of negative news in our view. This is a sector likely to offer good opportunity for the next bull market, but with inflation improvement (and greater confidence in the economic outlook) likely to take some time, accompanied by lackluster relative strength trends, we remain Equal Weight for now.
EQUAL WEIGHT	COMMUNICATION SERVICES	8.2%	Communication Services remain a very unloved sector with relative performance continuing its downward trend. Fundamental trends are weak, and earnings estimates are being revised down at the worst rate of all sectors. While valuation is not a great timing indicator, we do note that the sector trades at the low end of its 10-year P/E range (and lowest on relative basis). We stick with an Equal Weight stance, but recommend patience and selectivity when accumulating favored stocks.
EQUAL WEIGHT	INDUSTRIALS	7.8%	Industrials have held up relatively well this year, which comes in stark contrast to growing concerns over economic contraction. We are encouraged by the strength, along with relatively constructive fundamentals in Q2 earnings season. But global economic weakness is likely to weigh on manufacturing trends ahead and may act as a headwind to relative performance. We remain Equal Weight for now.
EQUAL WEIGHT	MATERIALS	2.5%	Materials have underperformed since the broad commodity complex moved lower in mid-June. While valuation is cheap, we view the strong US dollar and weaker commodity prices as headwinds to the sector. We maintain an Equal Weight stance.
EQUAL WEIGHT	REAL ESTATE	2.8%	With bond yields rising again of late and sector valuation just in line with its 10-year average, we view the Real Estate risk/reward as balanced. Our Equal Weight stance is supported by sideways relative strength trends this year.
UNDERWEIGHT	CONSUMER STAPLES	6.7%	Consumer staples have benefitted from their low beta, more defensive status in this year's volatility. And this may continue the longer market weakness occurs. However, fundamental trends are unattractive and the sector trades near the upper-end of its 10-year P/E range. Given our positive stance on the equity market over the next 12 months, we find other areas more attractive. Maintain Underweight.
UNDERWEIGHT	UTILITIES	3.2%	Utilities continue to perform well — trading back to their highs with relative performance also at new highs. Earnings consistency provides stability in the current environment, and Q2 results beat estimates by 9.9% — best of all sectors. That said, valuation is at the high end of its 10-year range. While the sector benefits from ongoing market volatility given its low beta, our positive 12-month outlook on equities leads us to favor other areas. Maintain Underweight.

DISCLOSURE

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

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

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

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

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

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

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

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

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

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

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

The process of rebalancing may result in tax consequences.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. Investors should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence.

The indexes mentioned are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market.

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

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