RAYMOND JAMES

VOLUME 14 | ISSUE 1 | JANUARY 2022

INVESTMENT STRATEGY QUARTERLY

LETTER FROM THE CHIEF INVESTMENT OFFICER page 2

ECONOMIC SNAPSHOT page 29

SECTOR SNAPSHOT page 30

2022 OUTLOOK

US Economy page 6 Supply Chains page 9 Washington Outlook page 12

US Equity page 15 International page 18 Fixed Income page 21 Energy page 25

Letter from the Chief Investment Officer

Carrying the Torch

Athletes at the Olympic Winter Games will either taste the thrill of victory or the agony of defeat. The same can be said for investors, as the easy victories over the last two years will become more challenging and hard fought in the year ahead.

2021 was all about speed – the fastest economic recovery on record and a history-making equity market run. And while speed is important, winter Olympic champions have demonstrated that precise execution is equally as important, especially as they grapple with weather, equipment, and slippery surfaces. For the markets, execution will be center stage – from the Federal Reserve's (Fed) managing of monetary policy, to corporate CEOs' ability to maintain healthy margins, to OPEC's oil supply decisions. With elevated valuations for most asset classes, *performance under pressure* will be unrelenting. At times, the margin of error may be slimmer than that of a figure skater nailing a Triple Lutz. However, we are optimistic that the economy and financial markets are well-trained, have favorable fundamentals, and are set to *carry the torch* for positive investment returns. That is why despite some periods of *tough sledding*, we forecast another *gold medal* year for the markets and economy.*

As we anxiously prepare to watch the Winter Games, we felt the Olympics *scored a 10* as a backdrop for our Ten Themes – so we prepared 10 captivating sports metaphors to accompany our views.

The US Economy is Ready to Take Off

The economy's *view from the top of the ski jump ramp* is a lot less scary now that effective vaccines are available. But what really propelled the 2021 results was the *momentum* from supportive fiscal and monetary policies. Now the economy is ready to *take off and fly* at an above-trend pace (2022 GDP: ~3.5%) for the second consecutive year – but this time on its own, without policy support. In fact, this is the first time annual economic growth will soar above ~3.5% for back-to-back years since 2000! The emergence of variants may cause some *resistance*, but COVID's gradual transition from a pandemic to endemic state should be the biggest tailwind. Consumers will probably return to more normal lives. And with still elevated cash balances, services spending will *lift off* and join already resilient goods consumption to improve the *aerodynamics* of the recovery. Brisk capital expenditures and the steady rebuilding of inventories should also help the economic expansion *go the distance.*

The Fed Must Adeptly Navigate the Fast-Moving Economy

Like a *bobsled hurtling down its track*, the global economy is racing to reopen, and pent-up demand is pushing inflation like the *g-forces in a tight turn*. The inflationary surge is also pushing the Fed into its *next heat* – tightening monetary policy. The Fed will be the *brakeman*, deciding if, and when, to slow the pace of growth to *throttle* back on inflation. We see the Fed *steering* in a less aggressive, more pragmatic manner than many expect, anticipating at least two well-telegraphed interest rate hikes that the market and economy will absorb like an *expected bump in a bobsled run*. The key question is what rate *boosts* will come in 2023, as this will have

Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your financial advisor to discuss the content of this publication in the context of your own unique circumstances. Published 1/3/2022. Material prepared by Raymond James as a resource for its financial advisors.

*Financial forecasts should NOT be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Expressions of opinion are as of this date and are subject to change. Past performance is not a guarantee or a predictor of future results.

> "When you're racing toward your investment goals, stick to your game plan and listen to coaching from your trusted advisor."

an impact on 2022 sentiment. We expect the rate of economic growth going *downhill* just enough to *freeze* inflationary pressures and grant the Fed the power of flexibility. While some observers talk of a potential yield curve inversion (where short-term rates move higher than longer-term rates), we think the *Fed sled* will be *driven* conservatively, remaining patient and relatively accommodative.

Yields Will Swerve Between the Gates

Downhill skiers reach impressive speeds when *weaving through gates* on the mountainside. Although skiers are going faster and faster, the 10-year Treasury yield has failed to reach its previous *peak rate* after each successive tightening cycle. This cycle will be no different. Structural factors like government debt, demographics, and globalization trends should keep the 10-year Treasury yield *zig zagging* within a tightly gated range, ending the year around 1.9%. The modest move higher is expected as the Fed removes its emergency measure *netting*, making for a *challenging run* for fixed income returns. Despite this, bonds still play a critical role for investors who need to *tuck* away from equity risk. Periodic bouts of volatility could create opportunities in the corporate credit markets as the macroeconomic backdrop remains positive, with low default rates and improving corporate earnings.

The Democratic 'Blue Wave' is Skating on Thin Ice

Given the *rough-and-ready rhetoric,* ice hockey seems to be the right sport to describe the 2022 political scene. The perceived dysfunction in DC has not stopped the economy and financial markets from *scoring* in recent years. There have been *scuffles* between policymakers along the way, but they never let the *puck stop* in meeting the needs of the economy and the American people. From the unprecedented $6 trillion in fiscal stimulus to not rolling back the Trump-era tax cuts, both parties have achieved *top-shelf* agenda items that stimulated the economy and supported equities. History suggests the incumbent party tends to lose seats in the House of Representatives in midterm elections, making gridlock the anticipated outcome. With politics in the *neutral zone,* few major policy shifts should make it *off the boards.* Market *fans* are likely to view this positively, as the economy has scored its share of *goals* and is no longer languishing in the *penalty box.*

Equities' Transition from Power and Speed to Targeted Precision

To win in biathlon, athletes must ski fast and shoot straight – two very different skills. The equity market excelled during the *speed portion* of the race, bullishly boosting equity valuations and notching a *record* rebound in earnings growth along its way. Now, the market is transitioning to a period where *precision* and *steadiness* are needed. Investors must become expert marksmen, aiming carefully at the right sectors and right companies. We have our *sights* set on more cyclical sectors, as their earnings should benefit from above-trend economic growth. Just as Olympic officials *salt the course* to turn slushy, slow snow into a super slick ice track, the continuation of shareholder-friendly actions and a still low interest rate environment will *salt* the S&P 500's course to our year-end target of 5,053.

Sector Exposure Will Steer Small Cap in the Right Direction

Luge competitors are the fastest of all Winter Games athletes, and the fact the sleds do not have brakes puts it among the riskiest of sports. The same could be said of small-cap equities, as they have faster earnings growth but a higher beta than large-cap equities. But unlike lugers who fly down the track on their backs, small-cap returns did not fall flat on their backs last year. However, they did

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

not travel on the *optimal line* down the course. Given our economic growth expectations for this year, especially the uptick in services spending, small-cap equities should offer investors an *edge.* The asset class's *shell of a sled* is composed of some of our preferred cyclical areas of the economy (e.g., Industrials, Financials, Energy). Relative to the S&P 500, valuations are trading at the lowest level on record, which also enhances our confidence they'll *come from behind.*

There are No 'Bindings' on Technological Re-Invention and Adoption

Many think of snowboarding as a quintessential winter sport, but it is still relatively new to the Olympics. Once, skiers were skeptical of its future, but its popularity has surged, and now there are courses around the globe. The pace of technological adoption has been similarly eager, with events such as the pandemic deepening our dependence on innovation. Just as the difficulty of the gravity-defying snowboarding stunts has increased, technology keeps reinventing itself, making revolutionary contributions to productivity. Like the *demonstration sports* in the Olympics, once fans try new technology, it becomes a permanent part of a business's performance. Just watch the development of the Metaverse, which is a *young gun* growth catalyst offering an online world with virtual reality, 3D holographic avatars, video, and other means of communications. *Rookies* like Metaverse are joining *veteran* catalysts such as cloud computing and 5G, pushing business plans for future tech spending to record levels. There's no limit to the stunts the sector can do, and its earnings power should continue to justify the seemingly lofty valuations.

Focusing On US Equities' Consistent Stride

In short track speed skating, victory margins are as thin as the *blade* and one small slip can lead to defeat. With the track measuring just over 100 meters, any athlete could win. Similarly, it is hard to pick a region as a short-term equity market winner given that varying supply chain bottlenecks, COVID surges, and differing policy responses are causing *false starts*. However, long-distance speed skaters, just like long-term investors, have more time and space to excel. Profitability ratios give the US the inside track versus other developed markets, but the Asian emerging markets are *gaining on us*. Between attractive valuations, exposure to high-growth tech industries, and scope for additional stimulus, investors should think globally as the International Olympic Committee does.

Oil Price Dynamics Will Find Their Balance

The energy market's performance in the recovery's *routine* has been anything but smooth, with COVID, inventory releases, and natural disasters causing oil prices to *twist, turn, spin, and lift.* However, supply and demand dynamics should find their *balance* and help oil prices avoid a fall. In past Olympics, Russian figure skating judges sometimes scored compatriot athletes too high and *competitors* too low. In the oil market, we still have a *Russian judge* and its OPEC fellow judges who are likely to continue to *prop up* the price. Therefore, we expect oil prices to remain around the *figure eight*(y) range. Prices at this level should no longer lead to *deductions* in the growing renewable energy space, and should instead, encourage the development of these markets.

Look Below the Surface for Opportunities

For sheer thrills, 2021 will be hard to beat! Between a blistering start to the equity bull market, healthy commodity gains, historically low interest rates, and the second smallest intra-year pullback since 2000, it is no wonder our forecasts don't have investors hanging on the edge of their seat. We can identify with curling players who barely get a blink of TV time compared to the skaters

and skiers. Yet, under the surface, curling is so tactical and complex it's sometimes called *chess on ice*. Similarly, there's a lot going on below the surface of our targets, and there are plenty of opportunities to add value to a portfolio. The news headlines will still come *sweeping in* — COVID variants, Fed tightening, midterm elections, geopolitics — *adding more or less friction* to the markets. For this reason, active management and selectivity are prudent to avoid an investment year with a *blank end* (no team scores any points).

No Resting on Laurels as the New Year Begins

Like the start of any big race, embarking on 2022 is both exciting and daunting. We hope the resilient economy and record bull market will proudly *carry the torch* into 2022, but there's always the fear of a *tumble on the slippery slope*. We favor the mindset of Mikaela Shiffrin, who is seeking to become the most decorated alpine skier in American history: *"When I am in the starting gate, it's just me and the hill."* There will always be the *distraction of the crowd*, but when you're racing toward your investment goals, stick to your *game plan* and listen to coaching from your trusted advisor. And we hope that our views serve as a reliable, integral part of your plan, and that your portfolio reaches the *top of the podium.*

Again, we wish you all the best for a wonderful 2022! Go U-S-A!

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

Investment Strategy Committee Members

Lawrence V. Adam, III, CFA, CIMA®, CFP® – Committee President, Chief Investment Officer, Private Client Group

Chris Bailey European Strategist, Raymond James Investment Services Ltd.*

Scott J. Brown, PhD Chief Economist, Raymond James

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

Doug Drabik Managing Director, Fixed Income Research

J. Michael Gibbs Managing Director, Equity Portfolio & Technical Strategy

Nick Goetze Managing Director, Fixed Income Solutions

Tracey Manzi, CFA Senior Investment Strategist, Investment Strategy

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

Joey Madere, CFA Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

Ed Mills Managing Director, Washington Policy Analyst, Equity Research

Pavel Molchanov Director, Energy Analyst, Equity Research

Chief Investment Office

Anne B. Platt, AWMA®, AIF®, RICP® – Committee Chair, Vice President, Investment Strategy

Giampiero Fuentes Investment Strategy Manager, Investment Strategy

Kailey Bodine Investment Strategy Analyst, Investment Strategy

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

2022 Economic Outlook: Turbulence Ahead

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

The US economy experienced a number of surprises in 2021, some good, some bad. The outlook for the coming year is likely to be even more volatile with inflation and Federal Reserve (Fed) policy as the major factors. Higher inflation in the spring of 2021 was narrow and expected to be transitory, but by the end of the year there were growing fears of a more persistent, broader increase in inflation. With that, financial markets expect tighter monetary policy and a possible policy mistake. Time will tell, as they say, but investors should be prepared for the ground to shift repeatedly in 2022.

Abraham Lincoln wrote, "If we could first know where we are, and whither we are tending, we could then better judge what to do, and how to do it." We began 2021 with expectations of a fiscal policy contraction (less support than in 2020). Democrats could gain control of the Senate if they won two Senatorial run-off elections in Georgia, which seemed unlikely. Yet, it happened. Still, the passage of a massive fiscal stimulus package would be difficult. With narrow majorities in the House and Senate, moderate Democrats would likely balk at adding so much to the federal debt. However, the incoming administration was determined not to repeat past mistakes (many economists believed the 2009 stimulus was not enough to offset the damage of the 2008 financial crisis). The $1.9 trillion American Rescue Plan Act of 2021 followed $3.2 trillion in stimulus passed in 2020 and helped propel strong growth in the first half of the year. Vaccines arrived earlier than anticipated, which helped the economy to reopen more rapidly.

> GDP growth should be slower, but still beyond a long-term sustainable pace. Our expectation is GDP growth will be approximately 3.5% in 2022.

GDP, SUPPLY CHAINS, & INFLATION

Real gross domestic product (GDP) rose at a 6.5% annual rate over the first two quarters, but that understates the economy's strength (as lower inventories and a wider trade deficit subtracted from the headline growth figure). For the key components of GDP, consumer spending rose at an 11.7% annual rate in the first half, while business fixed investment advanced 11.1%.

The arrival of the Delta variant, which was more transmissible than the original virus, combined with a large fraction of the population's reluctance to accept vaccines, dampened the pace of improvement in the third quarter. Growth was also restrained by

> “ The outlook for the coming year is likely to be even more volatile with inflation and Federal Reserve policy as the major factors. ”

supply constraints, especially in motor vehicle production. Recent data suggest a rebound in growth in the fourth quarter.

Supply chain difficulties occur in every economic recovery, but the ongoing pandemic meant that repairing production and transportation bottlenecks would take more time than usual. By late summer, port delays in Southeast Asia and Southern California contributed to a rough start to shipping for the holiday season. Supply issues were compounded by a surge in the demand for goods. During the pandemic, consumer spending shifted from services to goods. That shift was expected to unwind as the service side of the economy improved, but it didn't. Spending on consumer goods has remained well above the pre-pandemic trend.

Strong demand and restrained supply is a recipe for higher inflation. Inflation picked up in the spring, partly reflecting 'base effects' – a normalization in prices that had been depressed a year earlier – but there were restart pressures as well, especially evident in prices of raw materials and in new and used motor vehicles. In the spring, the increase in inflation was narrow, concentrated in just a few components of the Consumer Price Index, but by October, higher inflation was beginning to broaden across categories.

WAGES AND INFLATION

Inflation expectations play an important role in the Fed's policy outlook. It's not so much that inflation expectations predict actual inflation (they don't), it's that a mindset of higher inflation becomes engrained. Workers are likely to demand better wages and firms are more likely to try to raise prices. Near-term inflation expectations have risen, but longer-term inflation expectations have remained consistent with the Fed's goal.

Wage inflation tends to follow price inflation, but (depending on how easily firms can raise prices) higher wage inflation can reinforce higher price inflation, creating a wage-price spiral. This is the story we tell about the Great Inflation of the 1970s and early 1980s. Union power was much stronger then and there is a greater concentration of large firms now. Wage bargaining power has shifted toward firms and away from workers over the last 40 years. Still, the labor market is tight. Firms are reporting greater difficulty in hiring and retaining workers, quit rates hit record levels in the early autumn, and labor costs continue to rise.

Job growth was strong in 2021, although nonfarm payrolls are still below where they were before the recession. Labor force participation fell during the pandemic, reflecting dependent care issues and early retirements. There is even some recent evidence of un-retirements (returning to the labor force after retirement) for those in their late 50s and early 60s. However, fewer older Americans have gone into nursing homes during the pandemic and childcare is more expensive and less available. Labor force participation has been trending flat over the last year.

It's likely that higher wages will encourage a return to the workforce and slow the exit of older workers. President Biden's Build Back Better plan includes childcare support, but even if passed, it would take some time to implement. Beyond the short-term dynamics, the demographics of an aging population imply that labor force participation should trend lower over time.

FED POLICY

The Fed's view was that inflation pressures would likely be transitory, meaning not permanent. However, the rise in inflation expectations, continued supply chain strains, wage pressures, and the broadening of price increases is a worrisome combination. The Fed recognizes the risk of a more persistent increase in inflation.

The Fed began to reduce ('taper') its pace of asset purchases in November, lowering purchases of Treasury securities and mortgage-backed securities by $15 billion each month, but will accelerate that pace in January (taking purchases down to zero in March of 2022).

The Fed's Large-Scale Asset Purchase program (LSAP, commonly called quantitative easing or QE) was an important tool during the pandemic, but the economic recovery no longer needs that

> “ Most likely, the Fed will begin to raise short-term interest rates by the middle of 2022 and proceed gradually. ”

much support. Fed officials were worried that tapering could cause some disruptions in the credit markets, so its approach to tapering would be gradual. Fed officials emphasized that the decision to taper was separate from the decision to raise short-term interest rates. However, the increased risk of more persistent inflation has altered the outlook.

In 2019, the Fed revised its monetary policy framework. No longer would the Fed act preemptively to head off higher inflation. Instead, it would wait for inflation to show up, tolerating a moderate increase in inflation, but would still maintain a 2% long-term goal (as measured by the PCE Price Index). The Fed also broadened its employment objective, making it more inclusive. Low-wage workers and communities of color fare the worst during an economic downturn and are slower to recover in an expansion.

The Fed appears to face a tradeoff in 2022. If it waits too long to raise short-term interest rates and higher inflation becomes more rooted, it will eventually have to raise rates more to get inflation back down, slowing economic growth and risking a recession. Most likely, the Fed will begin to raise short-term interest rates by the middle of 2022 and proceed gradually, but a lot depends on the evolution of the economy.

So, what does all this imply for the 2022 economic outlook? Much of the growth in 2021 was a recovery from the pandemic. A key factor in the 2022 outlook is that there will be less to rebound from. With less ground to make up, GDP growth should be slower, but still beyond a long-term sustainable pace. Our expectation is GDP growth will be approximately 3.5% in 2022. Fiscal policy will be contractionary compared to 2021. Labor market constraints are also likely to remain an impediment to faster growth. Higher wages should pull many back into the workforce, providing some upside to the growth outlook, but it’s hard to say for certain.

We’re unlikely to see another round of government support for individuals. At the same time, consumer spending growth should remain supported by a strong trend in wage and salary income. Some of the 2021 government support was saved, showing up in higher balances in checking and savings accounts. That savings will be reduced over time, but should provide some near-term cushion for spending. While consumer spending did not shift back from goods to services in 2021, that ought to show up more in 2022 – but a lot depends on variants of the virus. A lockdown of the economy is unlikely, but fear of the virus may dissuade some individuals from returning to pre-pandemic spending patterns.

Strength in corporate profits supported business fixed investment in 2021. That support should continue in 2022, but at a more moderate pace.

Geopolitical tensions could be an issue in 2022, but the Fed will be the major factor, with the policy outlook expected to vary with the incoming data. Investors should watch developments closely and be prepared.

KEY TAKEAWAYS:

- The outlook for the coming year is likely to be more volatile than 2021 with inflation and Federal Reserve (Fed) policy as the major factors.
- Key components of GDP – consumer spending and business fixed investment – rose at an annual rate of 11.7% and 11.1%, respectively, in the first half.
- Near-term inflation expectations have risen, but longer-term inflation expectations have remained consistent with the Fed’s goal.
- GDP growth should be slower, but still beyond a long-term sustainable pace. Our expectation is GDP growth will be approximately 3.5% in 2022.

Spotlight on Supply Chains

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

Supply chain disruptions have wreaked havoc on the global economy since the pandemic began nearly two years ago. The logistical challenges of balancing factory shutdowns, health concerns, and an unprecedented demand surge have created bottlenecks across nearly every aspect of the global supply chain. While supply chain constraints remain severe, there are tentative signs that some of the logjams are beginning to ease.

SIGNS OF PEAK BOTTLENECK

For much of the last year, media headlines have been dominated by stories of port congestion, labor shortages, product delays, and elevated shipping costs. It should come as no surprise that supply chain disruptions have emerged as one of biggest buzzwords in 2021, not only in company earnings calls, but also among consumers. The White House has even appointed a task force to address transportation and logistics bottlenecks stemming from the pandemic. Not to make light of the seriousness of the situation, but when a market trend is splashed all over the news or makes its way onto the cover of a magazine, it usually indicates the trend has reached a turning point.

Supply chain logistics are notoriously complex, but one of the clearest measures of the disruptions caused by the pandemic can

While supply chain constraints remain severe, there are tentative signs that some of the logjams are beginning to ease.

be seen in the sharp acceleration in the Institute for Supply Management's (ISM) Supplier Deliveries Index. This timely measure, which captures the extent of supply chain delays in an economy, is running near its highest levels since the 1970s. While it is not unusual to see readings above 50 during economic recoveries, the lengthy delays have been exacerbated by exceptionally strong demand for goods during the pandemic, factory closures across key global manufacturing hubs such as China and Southeast Asia, and escalating shipping costs.

Although Asia was among the first to emerge from the pandemic, new waves of infections and low vaccination rates forced authorities to reimpose restrictions earlier in the year. This came at a time when vaccination rates ramped up sharply in other parts of the world and economies were kicking into high gear. With the global economy not in sync, the factory shutdowns across Asia aggravated an already overwhelmed supply chain. After months of growth-sapping lockdowns and significant improvements on the vaccine front, restrictions were relaxed, with many countries

now moving away from their zero-tolerance COVID policies. As factories across Asia revved up, supply chain constraints have started to ease. This is an important, yet understated, part of the supply chain story given China and the ASEAN region's dominant position in global trade.

Freight shipping rates started to roll over around the same time that Asian factories started to reopen. While it is not unusual to see shipping rates fall as seasonal demand starts to wane, this has been a welcomed change from the blistering rise in freight rates since the pandemic began. One of the key indicators we've been following is the Baltic Dry Index, which tracks the cost of shipping commodities across 23 different shipping routes. Since early October, Baltic Dry Index prices have plummeted over 50%. The cost to ship goods from Shanghai to Los Angeles is also down over 20% from its peak in September. As the chart below shows, the lengthening in supplier deliveries has moved in tandem with higher transportation costs. With freight costs now tumbling and Asian factories reopened, supplier delivery times are likely to correct.

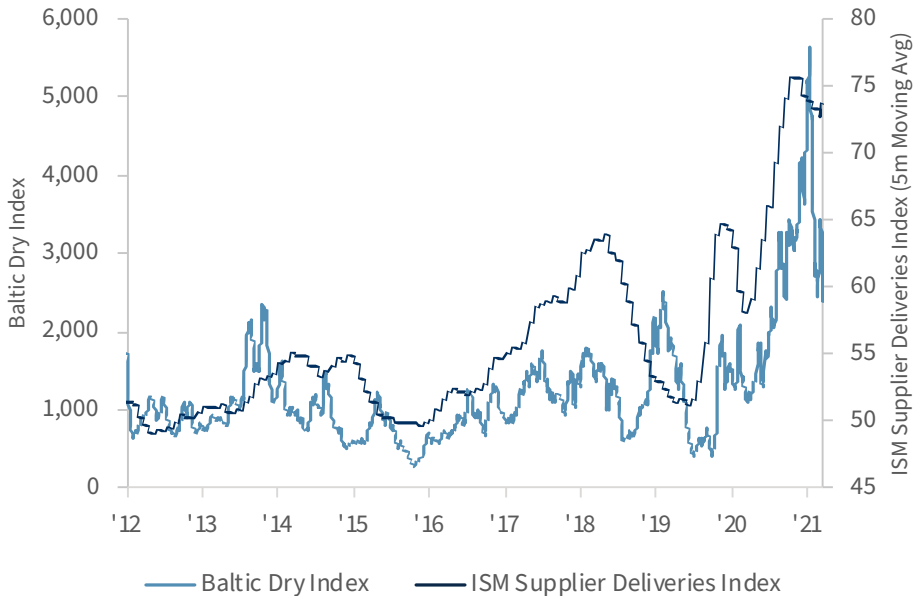
Port congestion remains an issue in the supply chain. While the major ports have a long way to go to reach pre-pandemic levels of efficiency, they are making considerable progress working through the current logistical issues. While the number of ships at anchor on the West Coast remains at elevated levels, other metrics suggest there is light at the end of the tunnel. For example, despite the challenges, the port of Los Angeles continues to process a record amount of cargo volume, the number of import containers sitting on the docks has fallen over 30% since late October and incoming traffic continues to fall. With seasonal volumes expected to slow further between now and early next year, the logjams at the ports should continue to ease.

The combination of soaring demand, saturated ports, and increased shipping costs have translated into a sharp acceleration in business costs and selling prices, which, for now, have been easily passed onto consumers. This is not all that surprising, as suppliers tend to have greater pricing power when there are widespread supply constraints. However, with the bottlenecks easing and transportation costs starting to retreat, it is reasonable to assume that the pipeline pressures that have translated into higher consumer prices will begin to fade. This would be welcome news for policymakers, who have become increasingly concerned about inflation, which is near a four-decade high.

Another timely indicator that provides a glimpse into the supply-demand imbalance is the ISM's Backlog of Orders Index. This measure shows a company's ability to meet consumer demand. Much like some of the other indicators that we follow, order backlogs have moderated significantly over the last few months. Despite all the news reports about low inventories and companies being unable to meet consumer demand, the decline in the

Shipping Rates Have Declined Substantially

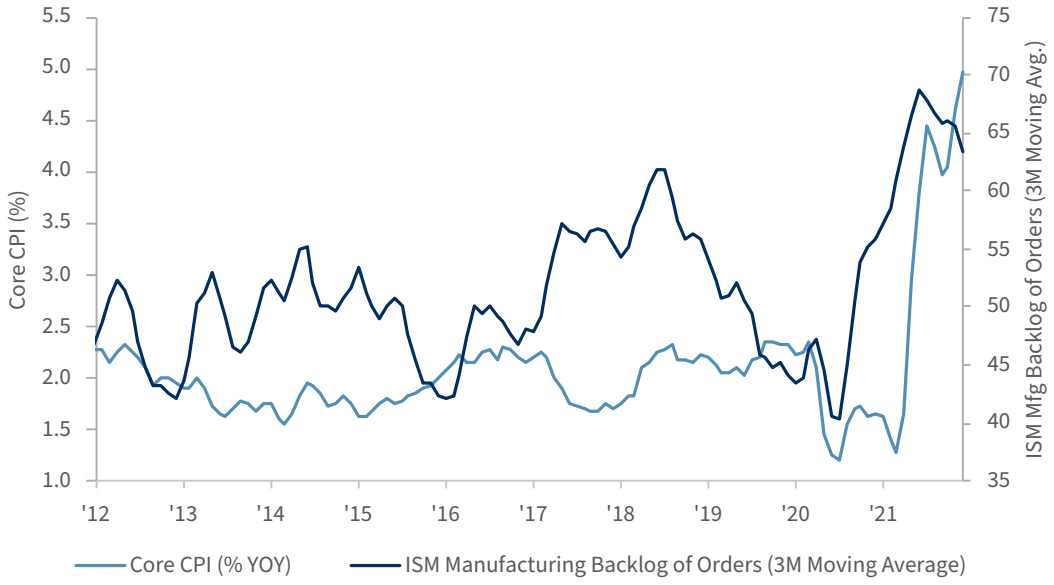
Rising transportation costs and longer delivery times reflect the severity of the recent supply chain disruptions. Sharp declines in shipping costs and improvements in supplier delivery times suggest that we may be at peak supply chain stress.



Source: FactSet, as of 12/17/2021

Supply Pressures Have Stoked Inflation

Supply chain pressures have had a direct impact on inflation. While still elevated, the recent downturn in the Backlog of Orders Index suggests suppliers are starting to catch up with demand. As suppliers continue to work through the imbalance, price pressures should start to fade.



Source: FactSet, as of 12/17/2021

backlog of orders suggests that companies are sourcing what they need to fulfill orders. With companies catching up on the orders as the supply chain normalizes, this should put further downward pressure on pockets of inflation that have driven headline inflation numbers higher.

While it is difficult to forecast when the supply chain will fully normalize, the recent developments we've flagged are encouraging signs. With new capacity being added across the supply chain, cargo spending shifting from sea to air, and a ton of goods still waiting to come onshore, it is highly likely that the inflationary environment we're grappling with today is setting up to bring significant disinflationary pressures later in 2022 or early 2023.

WHAT IMPLICATIONS DOES THIS HAVE FOR INFLATION?

The stresses in the supply chain have not derailed growth, but they have added a lot to inflation over the last year. The longer this exists, the more concerned policymakers get about inflation expectations becoming unanchored. With inflation now running at uncomfortably high levels, it is prudent for policymakers to be concerned. Hence, Chairman Jerome Powell's recent hawkish pivot. While the Fed is expected to shift to a less accommodative policy stance in 2022, policymakers should not have to tap on the brakes too hard if supply chain bottlenecks continue to ease and inflation pressures recede. This would be good news for risk assets, as the macro underpinnings of above-average economic growth and a still solid earnings outlook are likely to remain supportive.

KEY TAKEAWAYS:

- While the major ports have a long way to go to reach pre-pandemic levels of efficiency, they are making considerable progress working through the current logistical issues.
- With companies catching up on orders as the supply chain normalizes, this should put further downward pressure on the pockets of inflation that have driven headline inflation numbers higher.
- While the Fed is expected to shift to a less accommodative policy stance in 2022, policymakers should not have to tap on the brakes too hard if supply chain bottlenecks continue to ease and inflation pressures recede.

What to Expect from DC in 2022: Will DC Continue to Be a Market Tailwind?

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

The first year of a new presidential administration typically sees elevated market uncertainty due to policy and personnel changes that define the president's first term agenda. 2021 saw this and more, as major legislative packages covering COVID relief, domestic infrastructure investment, and care economy investments/tax reform dominated headlines virtually every month.

As we pivot toward 2022, the market will be closely following the impact of the DC agenda – inflation concerns, midterm elections, the regulatory agenda, and key policy proposals.

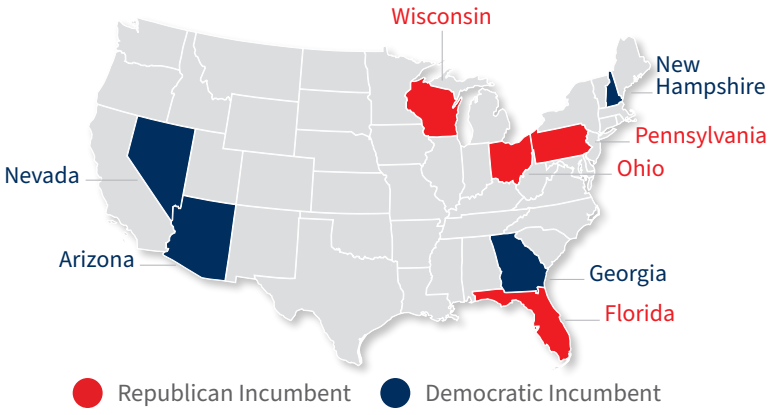
From a market perspective, a common DC axiom we've previously highlighted is that policy changes are often 'never as bad as you fear, nor as good as you hope' – and it's safe to say this held true for markets this year. Generally, policy proposals that concerned markets were moderated as the legislative process unfolded and DC delivered fiscal support to the economy while removing the overhang of many of the planned tax changes for individuals and corporations. As we pivot toward 2022, the market will be closely following the impact of the DC agenda – inflation concerns, midterm elections, the regulatory agenda, and key policy proposals. While the headlines out of DC have consistently highlighted the continued polarization of our political discourse, what has been striking to us is how much of the DC agenda continues to support the market. We are certain to have headline risk in 2022 and beyond, but overall the slim majorities in Congress and the potential change in congressional makeup post-midterms likely limit the overall policy agenda.

WHAT'S IN STORE FOR CONGRESS IN 2022?

Last year created new risks and opportunities for markets with the formulation and passage of several pieces of legislation tackling what can be described as the top economic concerns for the Biden administration; covering COVID-related disruption, infrastructure revitalization and investment, and gaps in the care economy that are seen as limiting the potential for long-term US economic growth (childcare, education, healthcare investment). The focus on the economic agenda limited time for debate on

other important policy areas that have been pushed to 2022. This includes defining the longer-term US competitive strategy on China, modernizing regulations for large technology companies, updating voting rights legislation, examining labor standards, and reforming US cannabis policy. Lawmakers introduced proposals to advance debate in all of these areas, and 2022 may be a breakthrough year for a select few. However, most are likely to be political issues that define party platforms ahead of the November elections. We see the highest chances of China competition legislation and technology policy advancing in 2022 given significant bipartisan interest. We view potential technology/anti-trust/privacy legislation driving headlines, but it is unclear if supporters can clear the hurdles necessary to get any legislation passed into law. Other priorities are likely to be more polarizing and drive political messaging to increase voter turnout with the angle that greater margins for either Republicans or Democrats in Congress can deliver the preferred policy outcome for voters. Overall, the focus on the election significantly limits the opportunity for major pieces of legislation outside of must-pass bills, which should notably reduce legislative and headline risk. A reduction in policy risk coupled with funding beginning to be injected into the economy for infrastructure and care economy priorities (should President Biden succeed in passing the Build Back Better legislation) further supports DC generally being a tailwind for markets in 2022.

Which Party Will Control the Senate?



2022 MIDTERMS: HISTORICAL PERSPECTIVE

Although we are almost a full year away from Election Day, it is worth noting the fundamental similarities between the current national political environment and metrics in 2018 which led to Democrats winning the House of Representatives by a decisive margin. While this result did not translate to the 2018 Senate race, it offered a first signal of a national environment that shifted control of DC to the Democratic Party in the 2020 presidential election cycle. There is still plenty of time for this race to change, but current data on President Biden's approval rating, President Biden's approval among Republican voters, a Republican lead in the Congressional generic ballot, and the number of Democratic lawmakers choosing to retire rather than run for reelection all point to sufficient gains for Republicans in this midterm cycle to capture the majority in the House and/or Senate.

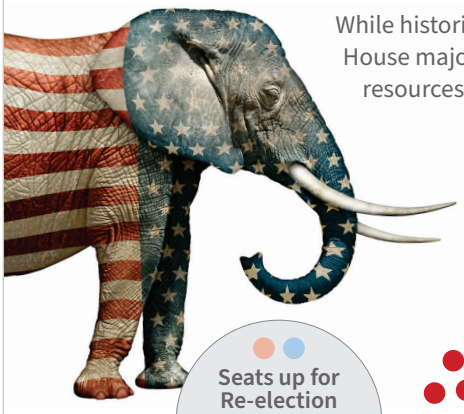
Going back to the 1980s, the president's party averages a loss of 23 House seats in the midterm elections. In the last two midterms following the election of a new president (2018 and 2010), the swings have been more pronounced. In 2018, Republicans lost 41 House seats and two Senate seats. In 2010, Democrats lost 63 House seats and six Senate seats. With a 50/50 Senate and Republicans needing to pick up five House seats for a majority, change could easily occur.

Control of the Senate will likely come down to eight key races: Arizona, Georgia, New Hampshire, and Nevada (Democratic held seats); and Florida, Ohio, Pennsylvania, and Wisconsin (Republican held seats). While historical trends and current polling data make a Republican House majority likely, Democrats will focus significant efforts and resources on improving the national sentiment for vulnerable Democratic incumbents. This is a further moderating dynamic in terms of market risk for 2022 as the administration seeks to improve economic conditions while launching key policy programs that passed into law in 2021.

From a market perspective, the hope will be that economic recovery will obviate the need for the elevated fiscal support we have seen in recent years, major tax changes that were proposed

The Senate

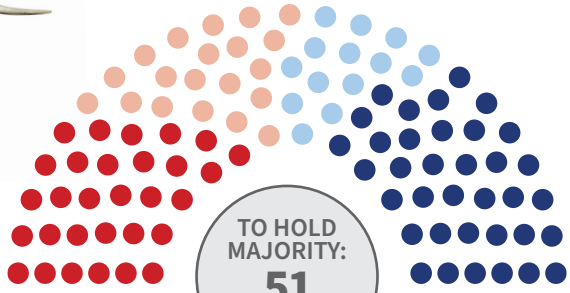
While historical trends and current polling data make a Republican House majority likely, Democrats will focus significant efforts and resources on improving the national sentiment for vulnerable Democratic incumbents.



Seats up for Re-election

8 Key Races

Arizona, Georgia, New Hampshire, Nevada, Florida, Ohio, Pennsylvania, Wisconsin



50 REPUBLICANS

TO HOLD MAJORITY: **51** SEATS

50 DEMOCRATS

by the Biden administration will not come into fruition, future Congressional majorities make further tax changes unlikely, the reappointment of Jerome Powell at the Fed will focus on inflation, and major DC policy changes remain unlikely. Regulatory changes remain the biggest wildcard and will be the driver of sentiment and will impact specific companies and/or industries. However, we view their impact as more targeted than as an overall market risk.

In sum, the policy setup for the year ahead likely boosts DC's impact as a market tailwind. The November election will serve as a marker for both the second half of President Biden's first term and the (early) national environment for the 2024 presidential election. Significant Republican gains in Congress would see a return to a historically market-positive DC gridlock scenario, and investor attention at the end of this year will turn to implementation of Biden's first-half legislative agenda as well as the potential direction of US policy tied to the 2024 election cycle.

> "Regulatory changes remain the biggest wildcard and will be the driver of sentiment and will impact specific companies and/or industries."

KEY TAKEAWAYS:

- Important policy areas for 2022 include defining the longer-term US competitive strategy on China, modernizing regulations for large technology companies, updating voting rights legislation, examining labor standards, and reforming US cannabis policy.
- A reduction in policy risk coupled with funding beginning to be injected into the economy for infrastructure and care economy priorities (should President Biden succeed in passing the Build Back Better legislation) further supports DC generally being a tailwind for markets in 2022.
- Control of the Senate will likely come down to eight key races: Arizona, Georgia, New Hampshire, and Nevada (Democratic-held seats); and Florida, Ohio, Pennsylvania, and Wisconsin (Republican held seats).
- Regulatory changes remain the biggest wildcard and will be the driver of sentiment and will impact specific companies and/or industries.

2022 Equity Outlook: Bullish on Earnings

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

2021 was a banner year for equities, as enormous fiscal and monetary stimulus through the pandemic supported the strongest economic and earnings growth in decades during the reopening. The S&P 500 Index experienced a glide-path higher (largest intra-year pullback being just 5.2%), though there was plenty of action beneath the surface with periods of rotation between the more technology-oriented and recovery-oriented areas. As we move into 2022, we remain positive on equity markets but believe the pace of market ascent should moderate and normal periods of volatility should return as Fed policy normalizes, along with the rate of economic and earnings growth. We recommend a balanced, but pro-cyclical tilt to portfolio positioning and would look to use pullbacks and rotation in favored stocks and sectors as an opportunity.

EARNINGS ENGINE KEEPS CHUGGING

Earnings are the long-term driver of equities, and we expect above-trend economic growth to support solid earnings growth in 2022. COVID waves continue to impact supply chains globally, but importantly consumer demand remains very strong. This is effectively leading to an elongation of the earnings recovery as corporate sales are being delayed (rather than lost). Order backlogs are at record highs and inventories remain exceptionally low (as supply has been unable to match demand). As these inventories get replenished, new orders are likely to remain elevated which bodes well for fundamental momentum over the next year. Also, S&P 500 operating margins have held up very well (at record highs), through the rising cost environment; and we believe supply chain pressures and inflation are likely to ease over the next year as the recovery progresses. This, along with the unlikelihood of broadly higher tax rates (15% minimum corporate tax rate becoming more likely), contributes to our above consensus S&P 500 earnings estimate of $235.

VALUATIONS JUSTIFIED BY LOW INTEREST RATES

S&P 500 valuation is elevated but acceptable as long as interest rates stay low and inflation moderates back to a more normal 2% to 3% level. Many investors point out that the S&P 500 P/E has not been this high since the dotcom bubble (and that is true), however interest rates were over 6% back then versus 1.5% now. Moreover, the difference in the S&P 500 earnings yield and US 10-year Treasury yield is 2.9% (versus -2.7% in 2000). From similar equity risk premiums historically, the S&P 500 has averaged a solid 8.3% compounded annual

> "Given that the Fed has been so important to equity markets since the credit crisis, the Fed's hawkish pivot toward more normalized monetary policy could come with more moderate returns and normal volatility/choppiness in 2022."

return over the next three years with a relatively narrow standard deviation of returns (max return: 17.6%, worst return: -2.4%). In our view, equity versus bond valuation supports positive, but moderating equity returns in the outlook. To be sure, we believe that valuations will normalize over the next year, but we do not expect it to outweigh the earnings recovery, providing upside to equities. We use a 21.5x P/E on our 2022 earnings estimate of $235 to receive a 5,053 price objective on the S&P 500 (9% higher from current levels, before dividends).

S&P 500 TARGET AND RISKS TO OUR VIEW

The biggest risk over the next year (as we see it now) is if inflation proves sticky and investor sentiment shifts to a stance of belief that the Fed is behind the curve. Sustainably higher inflation can not only impact margins, but would also likely result in the Fed becoming tighter than expected – both of which can impact credit conditions and valuation. We view the Fed's more hawkish pivot (three rate hikes expected in 2022) as prudent given very loose financial conditions, an improving jobs market, and elevated inflation. However, given that the Fed has been so important to equity markets since the credit crisis, a normalization of monetary policy could come with more moderate returns and normal volatility in 2022. With Fed policy becoming much more telegraphed and uniform over time (rather than a surprise), choppiness may occur in the lead up to the first rate hike. In looking at the last two rate hike cycles (and granted each period is different), the S&P 500 experienced a 12% to 14% pullback around the first rate hike in 2015 (though the US was in the midst of a manufacturing recession) along with a more normal 8% pullback around the initial rate hike in 2004. Rate hikes alone do not derail equity markets and concerns become more heightened following a yield curve inversion, which is far off. However, the Fed's hawkish pivot from ultra-lenient policy could come with more normal volatility/choppiness than what investors have grown accustomed to since March 2020. With overall conditions likely to remain healthy, weakness can be used opportunistically.

COVID mutations and waves of infection can also impact economic activity and, in turn, sentiment and volatility. However, the market impact is likely to decline in severity as global vaccination and immunization rates, along with therapeutics, improve. We continue to view the positives (above-trend economic growth, solid earnings growth, healthy US consumer, and relative value of stocks versus bonds) as outweighing the negatives (inflation, investor perception of Fed's path, virus mutations/waves, and elevated valuation). As mentioned previously, we have a base case S&P 500 target of 5,053. Our bull case scenario produces an S&P 500 target of 5,513 ($245 EPS, 22.5x P/E) and our bear case scenario produces a 4,388 target ($225 EPS, 19.5x P/E).

Positives Outweigh Negatives

Positives	Negatives
• Above-trend economic growth	• Potential sticky inflation
• Solid earnings growth	• Investor perception of Fed's path
• Healthy US consumer	• Virus mutations
• Relative value of stocks versus bonds	• Elevated valuation

2022 Year-End Outlook

S&P 500	EPS ESTIMATE	P/E	PRICE
Bull Case	$245	22.5x	5,513
Base Case	$235	21.5x	5,053
Bear Case	$225	19.5x	4,388

Source: Raymond James Equity Portfolio & Technical Strategy

PORTFOLIO POSITIONING

At the sector level, we expect rotation (between the recovery-oriented and technology-oriented areas) to continue beneath the surface, all within an overall positive market backdrop. Our recommendation is to stick with a balanced, but pro-cyclical tilt

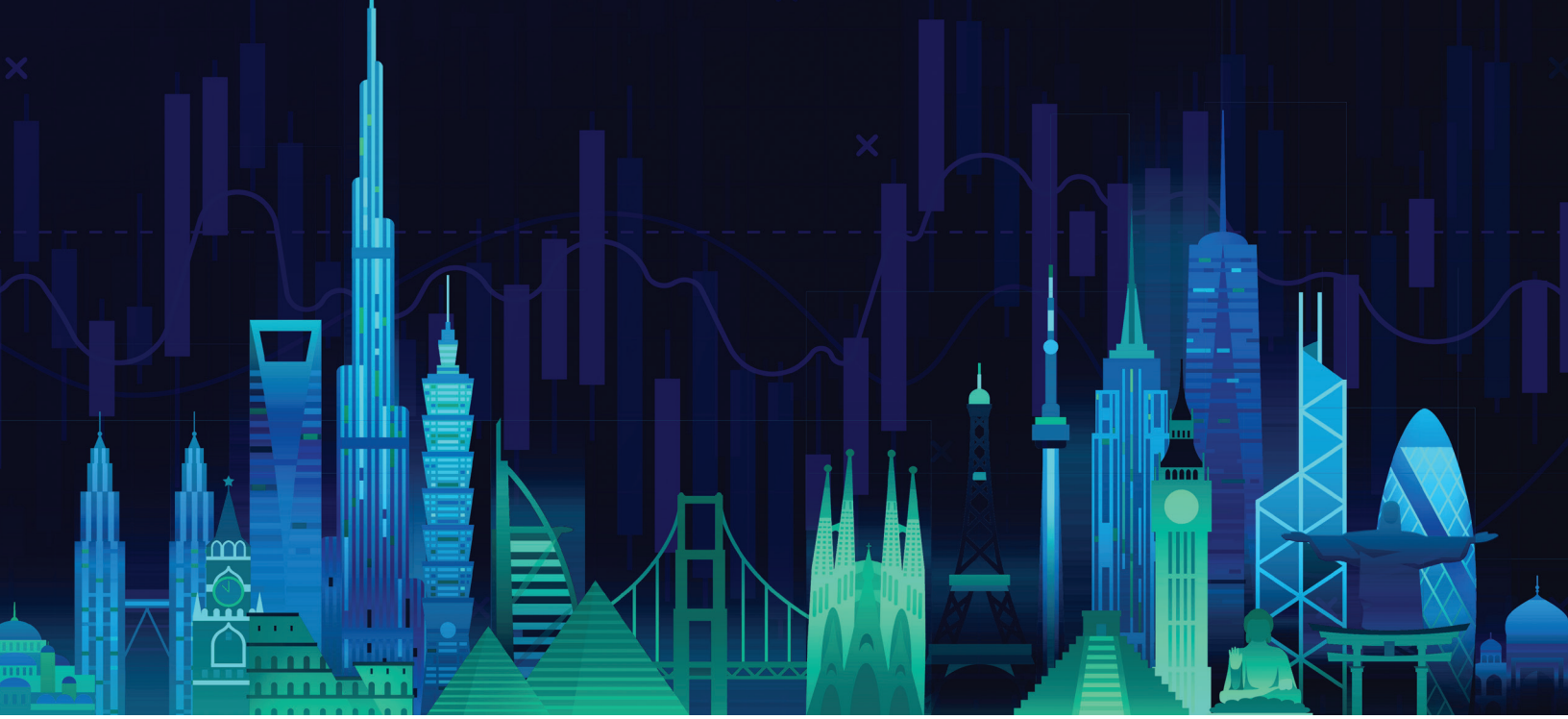
Sector Views

to portfolio positioning and to remain underweight the more defensive areas (e.g., Consumer Staples, Utilities). We believe the potential is there for areas more levered to the economic recovery to drive performance, but relative stock momentum has not proven sustainable yet in aggregate with the recent Delta and Omicron variants delaying global reopenings. On the flip side, Technology fundamentals are very strong with a long runway, and COVID accelerated the secular trends of economic digitization. Technology valuation is elevated but can remain so with interest rates staying stubbornly low. In our view, as interest rates grind higher and economies normalize, other areas can offer more leverage to the recovery. Investors have to find the right balance between these areas because global COVID cases and interest rate movements continue to have outsized influences on sector rotation. We recommend a healthy allocation to technology-oriented areas, but would also overweight Financials, Energy, Industrials, and Consumer Discretionary.

These thoughts also apply to the economically-sensitive small caps. We believe that the small caps can outperform over the next six to twelve months on stronger earnings growth, more favorable estimate revision trends, and an attractive valuation relative to the large caps. The group has less exposure to Technology than the large caps, which has been a headwind to sustainable outperformance, but also contains more leverage to the economic recovery/reopening. Additionally, the small caps trade below their 20-year average P/E at 16.3x (18x average), while the large caps trade at 23.2x (a 33% premium to their 17.5x 20-year average). Relative performance momentum has not proven sustainable yet, so we recommend accumulating the small caps on weakness and would increase conviction when/if relative strength is able to improve.

KEY TAKEAWAYS:

- We remain positive on equity markets but believe the pace of market ascent should moderate and volatility should normalize as the rate of economic and earnings growth does.
- We expect above-trend economic growth to support solid earnings growth in 2022.
- S&P 500 operating margins have held up very well (at record-high levels) through the rising cost environment.
- We have an above-consensus S&P 500 earnings estimate of $235.
- We continue to view the positives (above-trend economic growth, solid earnings growth, healthy US consumer, and relative value of stocks versus bonds) as outweighing the negatives (inflation, investor perception of Fed's path, virus mutations/waves, and elevated valuation).



The Rest of the World in 2022

Chris Bailey, *European Strategist,* Raymond James Investment Services Ltd*

This was a challenging year for the whole world, but judging by the full year equity market losses in Latin America, China, and (outside of India) many other emerging market indices, even recovering global economic growth numbers did not provide assistance. Meanwhile positive local currency performance from equity indices in the UK, Europe, and Japan were countered in recent months by a fall in the value of the pound, euro, and yen against the dollar. Little wonder that whilst global value stock indices hit a record 40-plus year low against global growth sector equivalents, global emerging market indices – with nearly half the index focused on China – fell to a relative low against the sector diversified S&P 500 Index not seen since late 2002. Meanwhile in Europe, regional equity indices traded at a record discount to their American peers since the launch of the euro in early January 1999. You can see why even globally focused investors have spent recent years adding to their US equity allocations.

COMPARING MARKET PERFORMANCE

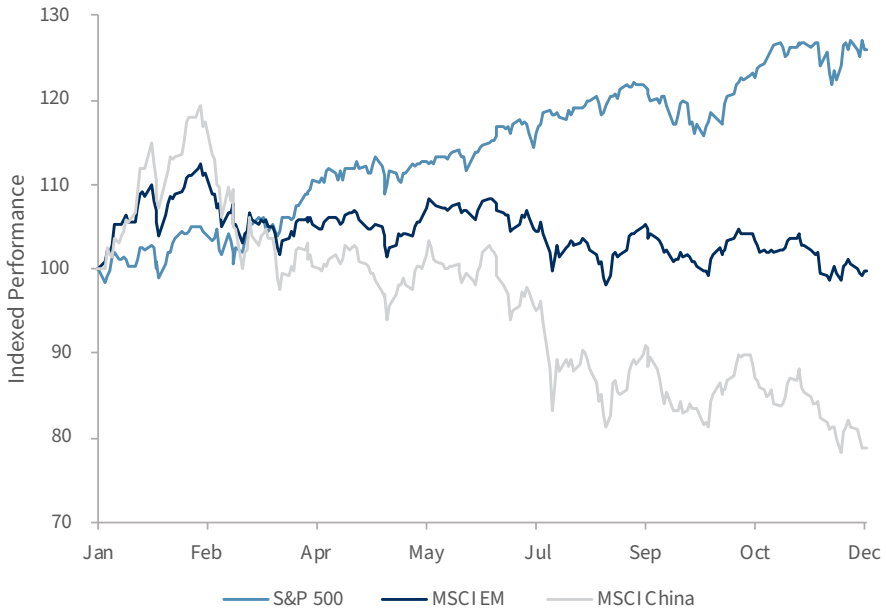
Underperformance can happen for many reasons. The key for comparing the rest of the developed world with the United States has, over the last 12 years, been relative economic growth levels. An aging and highly indebted Japanese economy has naturally struggled over the last 30 years, a challenge which has been little assisted by the introduction of negative interest rates. This latter policy was copied by the European Central Bank (ECB) over seven years ago, with regional challenges – and global investor allocations – further impacted from the UK's decision in 2016 to narrowly vote for Brexit and leave the European Union, raising fears of considerable trade and economic growth angst. Whilst economic realities have not been terrible, relative economic growth dullness and – especially in the UK and Europe – a relative lack of Technology sector growth companies, held back the allocations of many global fund managers.

The same could not be said of the largest four emerging market economies of China, Taiwan, South Korea, and India who collectively account for just over three-quarters of global emerging market indices. Economic growth numbers have remained strong, with the economies in both China and Taiwan generating a positive GDP number for full year 2020, despite the

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

Emerging Market Performance Weighed Down by China

Since February of 2021, China has significantly underperformed the S&P 500, dragging the broad emerging market (EM) index along with it. A bounce back in China would boost EM performance, as it makes up one-third of the index.



Source: Factset, as of 12/17/2021

> Growing emerging market economic power is an inevitable part of the 2020s.

COVID-19 challenges. Whilst populations are aging, the scope for rising consumer expenditure and technological application have been notable drivers over recent years.

Economic evolution – especially in the billion people plus populations of both China and India – takes time, especially in the former with its all-powerful Chinese Communist Party. Whilst the country's former leader Deng Xiaoping once noted that "to get rich is glorious," the last 18 months have seen the country's current leader Xi Jinping focused on the rise of the importance of 'common prosperity,' which has caused crackdowns on many important consumer, technology, and property sector companies in a manner materially different from forcing extra competition via breaking up dominant companies, as seen in a number of sectors in the developed world over the last century.

However, growing emerging market economic power is an inevitable part of the 2020s. The initial rise – and further rise – of the consumer economy has been a dominant part of developed market growth over the past 30 years, as reflected by personal debt levels across America, the UK, and many other countries. From a trade perspective, there is a reason why the US president has spoken to the Chinese president three times this year. Whilst plenty of potential strategic challenges could be apparent during the 2020s, there is already too much in current trade flows to ever stop the leaders talking.

EMERGING MARKET OPPORTUNITIES

Emerging markets fundamentally have two opportunities and two choices. Beyond the rise of consumer spending, all emerging markets retain a material internal development opportunity. Whilst every country in the world can see day-to-day life positively evolved by better education, healthcare, and business efficiency, the scope for positive change and impacts is most proportionately apparent in the emerging market nations. This has always been the case, as shown by the material improvements of the South Korean and Taiwanese economies over the last 50

> “ 2022 does offer some positive opportunities for equity and currency investors in developed markets outside of the United States, aided by modest absolute valuations, higher dividend yields, and more diversified sector exposures. ”

years, countries which today should probably be regarded as developed economy nations. Sadly, in some other countries elsewhere, a combination of politics, wars, crime, and corruption has been negatively impactful. Fortunately the rise of knowledge and awareness is improving.

As for the choices, it is much more than the ‘Belt and Road’ expenditure by the developing Chinese economy to a range of its emerging market peers across the world. The majority of large or mid-cap developed market companies will observe significant opportunities to grow their sales and profitability driven by rising populations and wealth levels in the emerging markets. The smartest choice for all emerging market countries is to encourage local entrepreneurs to find their own products and solutions. Slowly this is occurring more, reflected by the evolving research monitoring lists of global analysts and fund managers.

The second choice pertains to climate and environmental issues, which were discussed by 200 different countries in Glasgow, Scotland, during last November’s United Nations conference (COP26). The consequences of climate change for example, droughts, wildfires, and power grid outages have an outsized impact on lower-income countries. The solutions, however, need to be much more global in scope. While many emerging markets feel that the developed world needs to take the lead on energy transition – for example, shifting from coal to renewable power – emerging markets play a key role in production of clean energy metals such as copper, nickel, cobalt, and the rare earth metals. The anticipated COP27 conference in Egypt next November may well see growing awareness of the essential role of the emerging markets.

IMPACT ON DEVELOPED MARKETS

Emerging market sales and profit generation is also a deeper part of developed market (outside of the United States) countries, reflecting the last 500 years of the UK and Europe. Additionally, Brexit concerns have partially faded away as the realities of geographic proximity and trade exposure led to the forging of a compromise deal just prior to the emergence of COVID-19 challenges. This is why global fund management allocation data has quietly started to see European equity allocations start to improve versus the norm of the last three to five years. 2022 does offer some positive opportunities for equity and currency investors in developed markets outside of the United States, aided by modest absolute valuations, higher dividend yields, and more diversified sector exposures. However, the real key is centred on perceptions towards the emerging markets and whether they can start to counter nearly two decades of underperformance against the US indices. Assuming general further COVID-19 progress during the year, fund management surveys over the next few quarters may see emerging market portfolio allocations start to build again, compared to the average holding levels of the last few years. Change never happens immediately, but thoughts that are at least half full – rather than being half empty – can start to help.

KEY TAKEAWAYS:

- The initial rise – and further rise – of the consumer economy has been a dominant part of developed market growth over the past 30 years.
- Whilst every country in the world can see day-to-day life positively evolved by better education, healthcare, and business efficiency, the scope for positive change and impacts is most proportionately apparent in the emerging market nations.
- 2022 does offer some positive opportunities for equity and currency investors in developed markets outside of the United States, aided by modest absolute valuations, higher dividend yields, and more diversified sector exposures.

2022 Fixed Income Outlook: Rethinking Fixed Income

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

Any doubt that 'extraordinary' central bank policies were simply a Great Financial Crisis construct has been erased by the COVID-19 pandemic period. Quantitative easing, asset purchases, etc., are permanent components of monetary policy. Income investing, including investor behavior and corporate capital allocation decisions, are altered as a consequence. Many financial planning commentaries are suggesting lowering retirement drawdown levels (Morningstar to 3.3% from 4%) with interest rates low and potentially moving higher, equity markets at all-time highs, and inflation dominating headlines.

REGIME CHANGE?

A regime change (reflation/inflation) is upon us, and uncertainty around policy and the economy is rising. However, 4% to 5% drawdowns are attainable with flexible and opportunistic allocations among different income producing assets or intra-company capital structures. Bonds, stocks, and preferred shares of large-cap US companies can have significantly different yield and risk profiles. The opportunity set for individual investors to generate income is not limited to asset class categorization. Investors can manage volatility, optimize cash flow, and mitigate inflation risk by comparing risk/income tradeoffs in different income producing instruments.

Predictability is a central part of income investing, but it will take more than a 50/50 or 60/40 static split and simple rules-based allocations to meet objectives and outpace cost of living. Capital markets are in transition to a reflating mindset. Successful income planning and investing now requires actively managing market and inflation risk.

INFLATION

As we have postulated, the post COVID-19 economy will wrestle with supply constraints while aggregate demand continues to accelerate. Even the most ardent proponents of the 'transitory' inflation narrative are conceding price level increases are 'persistent.' Income investors are now faced with erosion of purchasing power if portfolios cannot keep up with price level changes. On top of this, rate policy changes are imminent, including tapering

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

Example of Relative Yield Comparison Based On Company Capital Structure

COMPANY A Multinational Telecom	• Mature, utility-like business • $25.2bn TTM free-cash-flow vs. $10.3bn dividends	10-Year Debt Yield	2.4%
		Dividend Yield	4.5%
COMPANY B Leading Dollar Store Chain	• Stable credit profile with prudent financial policy • Counter-cyclical business characteristics	10-Year Debt Yield	2.4%
		Dividend Yield	0.8%
COMPANY C Financial Services Firm	• Long history of conservative management • Clear beneficiary from industry consolidation	10-Year Debt Yield	2.1%
		Preferred Security Yield	3.1%
		Dividend Yield	1.0%

Source: Factset and Bloomberg, as of 9/30/2021

bond purchases and a potentially faster liftoff for rate hikes. Consider that since Federal Reserve (Fed) Chair Jerome Powell announced tapering, the 10-year US Treasury yield has moved up nearly 50 basis points (0.50%). The shorter end of the US Treasury market is also signaling policy changes with the 2-year yield up 25 basis points (0.25%) over the same period.

Individual investors for taxable bonds are competing with two significant market participants, the Fed and levered institutional investors. The Fed has announced plans to slow purchases and levered players may turn more cautious as rate volatility continues to move higher. Both dynamics could increase market pressure on rates. The knock-on effect being individual investors may demand higher yields than the price indiscriminant Fed, and the levered carry trade stepping back.

So, with real rates (inflation adjusted) still negative, larger buyers slowing purchases, and rate normalization in 2022, near-term bond allocations should be modest and intermediate in maturity/duration. Our preference is for corporate bonds, even select below investment-grade credits, with duration below five years. Income return will be the main driver of performance of this rate transition period, and yield spreads for investment-grade debt average 100 basis points and are supported by the positive economic backdrop. Financial conditions are still near the loosest in history and spreads are well anchored suggesting a positive backdrop for risk markets generally.

The 5-year US Treasury rate is nearing 1.25%, so a 2% yield on corporate bonds is attainable. Cash returns are still anchored near zero. While holding cash seems 'safe,' purchasing power erosion and cost of lost income over the holding period are real risks. Higher fixed allocations and duration extensions will likely be more generous at some point in 2022, but the path will be bumpy as the economic cycle continues, requiring thoughtful allocation decisions. Let's remember that the 10-year yield was above 3% in 2018.

Conversely, income production in other parts of the capital markets (domestic, international equity, preferred shares) is accelerating. Recall that at the start of the pandemic, corporations issued record amounts of debt. Some for survival, but

> "Successful income planning and investing now requires actively managing market and inflation risk."

many others used the ultra-low rate period for building capacity for growth, returning cash to shareholders, and acquisitions. Rising dividend and buyback sentiment is evident in corporate earnings disclosures. Surging cash returns to equity holders puts buybacks and dividends near pre-pandemic levels.

So let's look at tradeoff between yield (naïve selection) and yield plus growth (considered selection).

DISPARITY IN YIELDS

Within S&P 500 dividend paying companies, there is disparity among yields. The top 20% (1st quintile) pay 4.5% yields, while the bottom 20% pay 0.56% yields. More importantly, growth rates for earnings, free-cash flows, and ultimately future yields are even more disparate. The highest-yielding companies today produce limited growth and pricing power to combat a reflating economic environment. A focus on above median-yielding companies, but not the highest (2nd quintile), with above median growth rates is optimal. High-quality dividend payers that have high revenue growth, low leverage, high margins, and barriers to entry can offset input costs with pricing increases. Such companies have dividend income growth rates of over 10% this year.

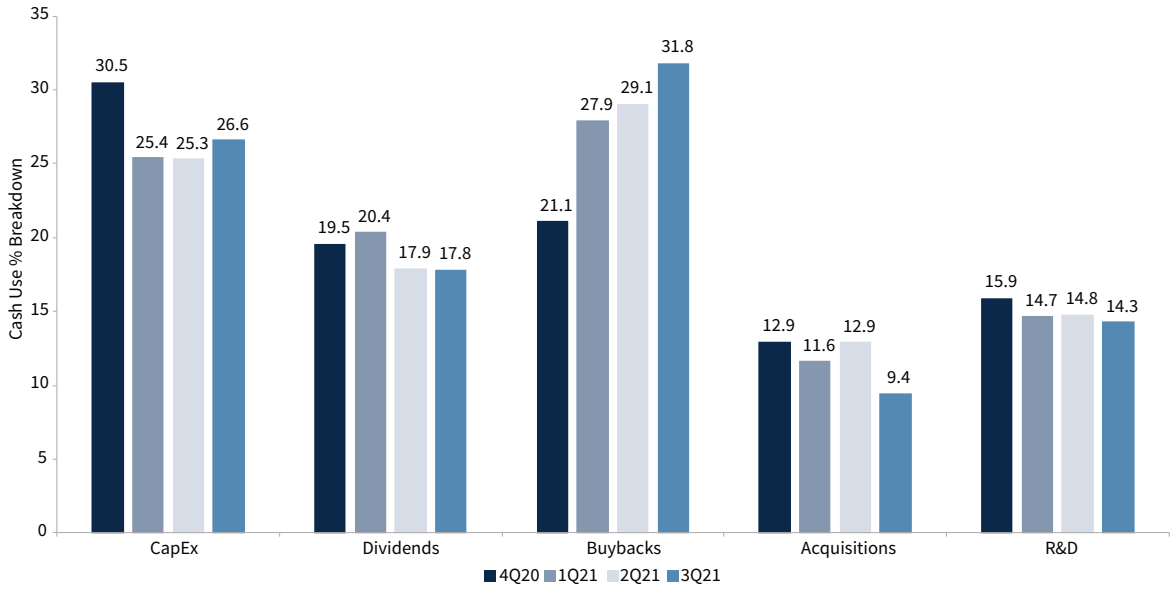
As professor Einstein quipped, "The eighth wonder of the world is the power of compound interest." The overall S&P 500 yield is about 1.28%. A 50% premium income target (reasonable) is close to 2%. Quintile 2 stocks produce income and growth over 7% in today's market with selective companies generating over 9%, potentially doubling investment income every seven to eight years.

Another way to look at this is that yield thresholds on invested dollars are more readily met if income planning and allocation begin prior to the need for income.

If the rate regime change holds, dividend-paying stocks may outperform even the pure growth side of the equity markets. 'Payers' have outperformed 'non-payers' since Powell's taper announcement and higher 10-year yields. Some basic intuition suggests that growth companies count on accelerated earnings growth in later years (hence high multiples) and a higher discount rate makes those earnings less valuable today.

How Are Companies Using Cash?

Rising dividend and buyback sentiment is evident in corporate earnings disclosures. Surging cash returns to equity holders puts buybacks and dividends near pre-pandemic levels.



Source: Factset, as of 12/17/2021

International Markets are Cheaper on a Relative Basis

The valuation discount for select international markets can be partially explained by growth prospects, as US earnings are projected to grow faster than these other markets.

Factset, as of 12/17/2021

LOOKING OUTSIDE THE US

Higher current yield investors broadening the investment opportunity set to include equities outside the US can supplement the search for yield at a better relative value. As of the end of Q3, companies in the MSCI US Index had a median dividend yield of around 0.8%, as contrasted with around 2.1% for both MSCI Europe and MSCI Pacific (Japan, Hong Kong, Singapore, Australia, and New Zealand).

As you might expect given those dividend yields, these foreign regions are also cheaper on a P/E multiple basis, with forward P/Es of 15x and 14x for MSCI Europe and MSCI Pacific, respectively, versus 22x for MSCI US. The valuation discount can be partially explained by growth prospects, as US earnings are projected to grow faster than these other markets, demonstrated by median forecasted long-term earnings growth rates of 13.6% for the US, versus 12.1% and 12.2% for Developed Europe and Asia, respectively.

Using bonds, preferred shares, and select dividend-oriented equities – domestic and international – retail investors have a variety of income versus risk tradeoffs. Considering the reflationary environment in the context of current and future income needs should guide proper allocation today, and maintain flexibility in the future.

KEY TAKEAWAYS:

- The opportunity set for individual investors to generate income is not limited to asset class categorization. Investors can manage volatility, optimize cash flow, and mitigate inflation risk by comparing risk/income tradeoffs in different income producing instruments.
- Our preference is for corporate bonds, even select below investment grade credits, with duration below five years.
- Using bonds, preferred shares, and select dividend-oriented equities – domestic and international – retail investors have a variety of income versus risk tradeoffs.

Energy Transition Is Here to Stay

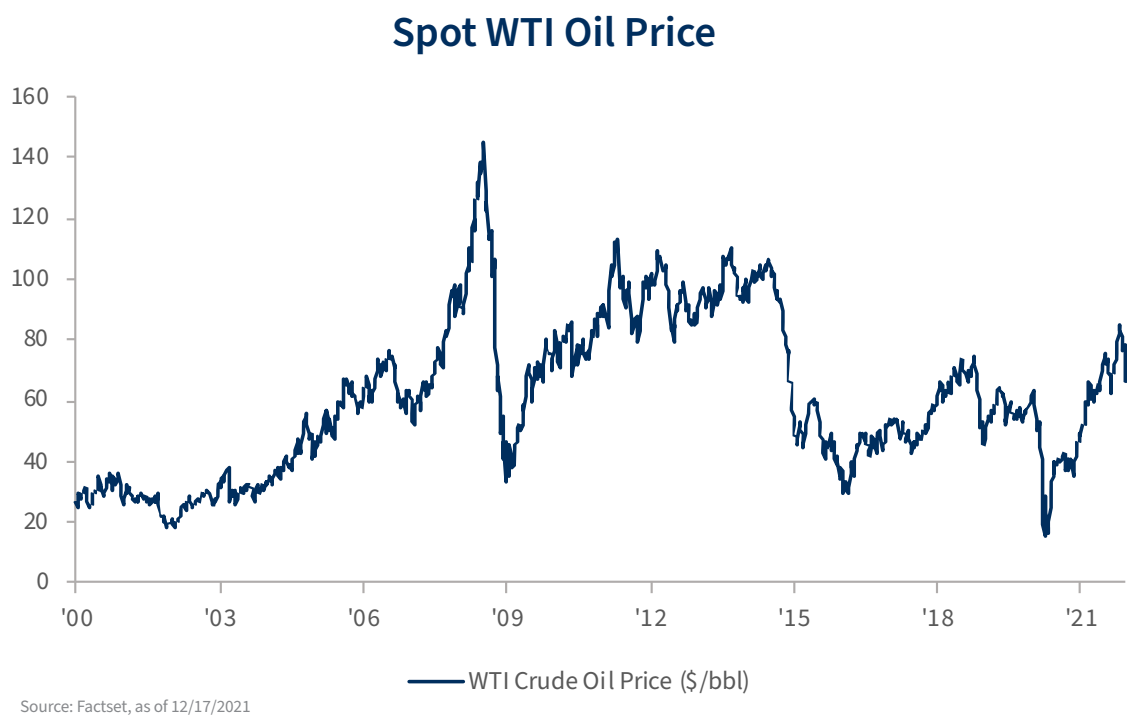
Pavel Molchanov, *Director, Energy Analyst,* Equity Research

As many of our readers are painfully aware, Energy had been the worst-performing sector of the US equity market in the decade prior to 2021. However, as is often the case, what had seemed utterly hopeless turned out to be the trough. From the COVID-impacted debacle of 2020, when fundamentals (remember negative oil prices?) as well as investor sentiment hit rock-bottom, Energy ended up being the best-performing sector of 2021, up 60%. This reflects the post-crisis rebound in the oil market, with spot oil prices rallying 50%, and US natural gas up a similar amount. That said, the oil and gas industry's cash flow approximately tripled in 2021, so in that sense, the stocks didn't do quite as well as some might have expected. The lesson here is that the market is always forward looking: with the commodity futures curve pointing to price declines in the years ahead, the stocks are pricing in less stellar, though still solid, profitability in the future. In an even broader sense, Energy remains less than 3% of S&P 500 market cap – down from as much as 13% a decade ago – illustrating that this remains quite a contrarian sector for investors.

> Energy transition is an irreversible megatrend – and, ultimately, more important for the Energy sector than either COVID or geopolitics.

OIL & NATURAL GAS OUTLOOK

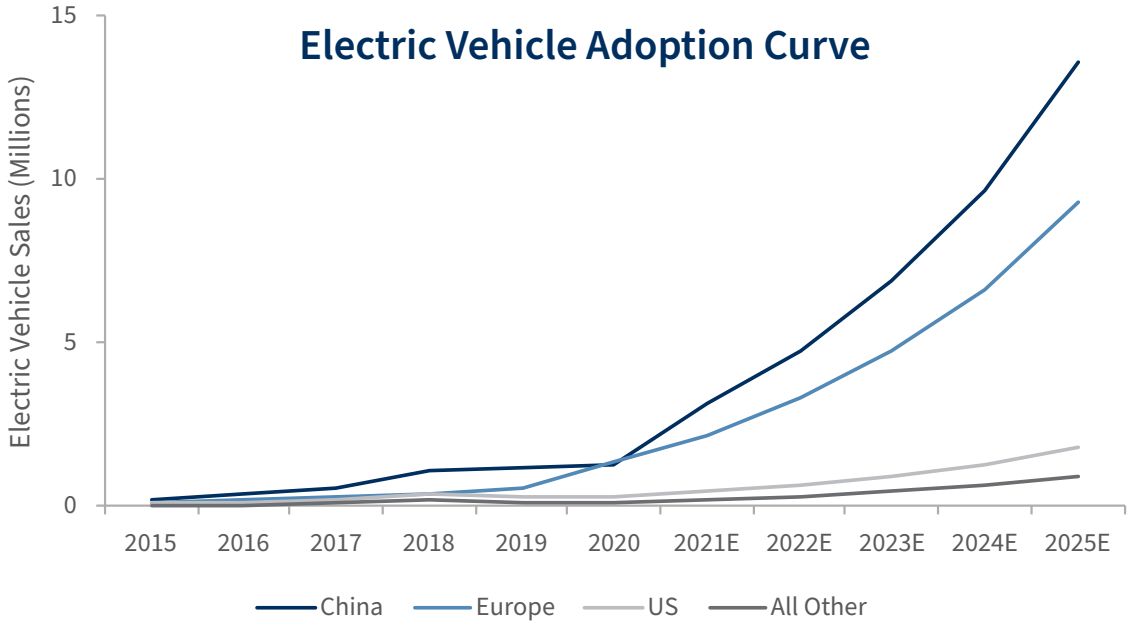
So, what does 2022 have in store for the oil market? Let's first acknowledge that predicting oil prices involves, to borrow a phrase, both 'known unknowns' and 'unknown unknowns.' Demand has essentially recovered to pre-COVID levels – hence the past year's bounce in the oil market to the highest levels since 2014 – and we anticipate that demand should continue to firm up. However, even with the global vaccination rate (one or more doses) approaching 60%, there is no escaping the fact that pandemic-related headwinds, especially in aviation, are still a headwind for demand. On the supply side of the equation, OPEC and Russia are gradually restoring production to pre-COVID levels: the only question is, how quickly this process will unfold. Meanwhile, the ongoing nuclear negotiations between Iran and major powers are a source of uncertainty vis-à-vis supply, and the same holds true of weather events such as hurricanes and wildfires. Finally, at a time of heightened inflationary concerns, macroeconomic question marks are also part of the backdrop. All that being said, we forecast that West Texas Intermediate (WTI) crude will



Source: Factset, as of 12/17/2021

average $75/Bbl in 2022, ending the year at $80/Bbl. Brent crude, the global benchmark, should remain a few dollars above WTI.

Natural gas is fundamentally regional in nature: prices on different continents can follow different patterns. In 2021, in fact, Europe was the standout for escalation in gas prices, amid the complex geopolitics surrounding gas supply from Russia. In response to unhappiness in Germany about the politically controversial Nord Stream 2 pipeline, Russia retaliated by curtailing exports. However, the US market was also very strong, for purely economic reasons: lack of investment in new supply at a time of strong demand from the post-crisis industrial recovery. In 2022, we envision the domestic Henry Hub benchmark averaging $4.50/Mcf. Gas is always more seasonal than oil, so weather-related uncertainty is inherently greater. Interestingly enough, the higher oil prices go, the more downward pressure it will put on gas prices. The reason is this: all else being equal, higher oil prices



Source: Raymond James Equity Research

incentivize more oil drilling and therefore more supply of what's known as associated gas, though it is true that oil and gas companies have become more disciplined with capital allocation, so the associated gas factor isn't as impactful as it has been historically.

ENERGY TRANSITION

While share prices of oil and gas companies continue to fluctuate with commodities, the past year also brought numerous reminders that energy transition is an irreversible megatrend – and, ultimately, more important for the Energy sector than either COVID or geopolitics. Energy transition refers to the gradual but inexorable trend away from fossil fuels, toward renewable and other low-carbon energy sources. This is happening for a combination of political/regulatory and economic/technological reasons. High commodity prices are an example of the latter category. When drivers are frustrated by expensive gasoline at the pump, they are more likely to buy an electric vehicle. Likewise, electric utilities unhappy about paying for expensive coal or natural gas are more likely to invest in wind and solar power plants. If, hypothetically, oil prices were to reach $100/Bbl – which, to be clear, we are not predicting – it would cause serious economic pain, but also have the side effect of accelerating the EV adoption curve. Recent headlines from China (coal shortages) and the UK (scarcity of drivers for delivering fuel) pointed to the importance of diversifying energy supply, even setting aside environmental considerations.

Near the end of 2021, the United Nations climate conference, COP26, drew attention to how governments around the world are approaching the issue of climate change. Broadly speaking, climate policy can be divided into 'sticks' and 'carrots.' Sticks include carbon trading programs – the largest ones are in the European Union and China – along with carbon taxes in countries such as Japan, South Africa, and Canada. These policies are designed to make carbon pollution more economically costly. Carrots include a wide range of incentives for clean energy technologies: everything from electric buses and green hydrogen (for businesses) to rooftop solar systems and energy-efficient appliances (for consumers). Needless to say, sticks are more politically sensitive, which explains why climate action at the federal level in the US – at a time when the Senate is divided 50/50 – will remain limited to

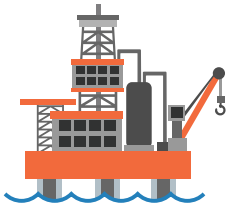
2022

Outlook on Prices: Looking Ahead

We expect to see oil prices increase throughout 2022 with lower prices earlier in the year and higher prices toward the end, averaging $75/Bbl for WTI and $78/Bbl for Brent.

WTI CRUDE

$80/Bbl



BRENT CRUDE

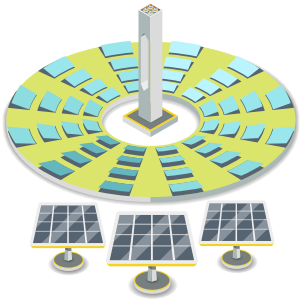
$83/Bbl

NATURAL GAS

$4.50/Mcf

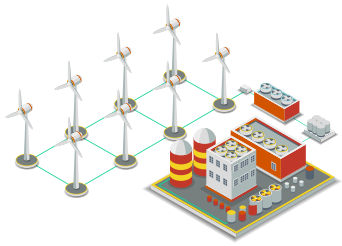
Source: Raymond James Equity Research

Low-Carbon Energy Technologies



SOLAR

- 4% of US electricity mix, but 40% of new power plants
- Highest market share in Hawaii, Puerto Rico, and California
- Internationally, key markets include China, India, Japan, and Germany



WIND

- 9% of US electricity mix, but 30% of new power plants
- Highest market share in the Midwest
- Internationally, key markets include China and the North Sea region

ELECTRIC VEHICLES

- 5% of US auto sales, up from 1% in 2015
- China and Europe together comprise more than 80% of global sales
- Several major automakers have pledged all models to be electric by 2035/2040

carrots for the foreseeable future. There are, however, more ambitious policies in politically progressive 'blue' states. Furthermore, there is an important role for voluntary, self-motivated action on the part of the private sector. Governments can legislate net zero CO_2 emissions (carbon neutrality), but in the absence of such policies, plenty of multinational companies have set analogous targets for themselves. At a time when one-third of all professionally managed assets in the US – equity and debt combined – are in ESG funds, shareholders are influencing companies to take action even if policymakers are slow to jump on this bandwagon.

KEY TAKEAWAYS:

- Pandemic-related headwinds, especially in aviation, are still a headwind for demand.
- We forecast that West Texas Intermediate (WTI) crude will average $75/Bbl in 2022, ending the year at $80/Bbl. Brent crude, the global benchmark, should remain a few dollars above WTI.
- Energy transition is an irreversible megatrend – and, ultimately, more important for the Energy sector than either COVID or geopolitics.

Economic Snapshot

The economic recovery is expected to continue in 2022, but toward 'a new normal.' Some changes, such as working from home and a shift in spending from services to goods, are likely to be long lasting. Higher inflation and more aggressive Federal Reserve policy are key risks. Increased labor force participation could add some upside to the growth outlook, but that remains uncertain.

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 above a long-term sustainable pace in 2022.
FAVORABLE	EMPLOYMENT	Nonfarm payrolls are still below where they were before the pandemic, but labor demand is strong. Better wages should lure many of those on the sidelines back into the workforce.
FAVORABLE	CONSUMER SPENDING	Job and wage growth should be supportive, although wages are generally not expected to keep pace with inflation (implying some reduction in consumer purchasing power).
FAVORABLE	BUSINESS INVESTMENT	Outside of commercial real estate, business fixed investment is expected to remain strong, supported by continued strength in earnings.
FAVORABLE	MANUFACTURING	Supply chain difficulties, materials shortages, and labor issues have continued, restraining output growth in a number of industries, but we should see some improvement in 2022.
FAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	Housing demand remains strong and mortgage rates are still relatively low. However, shortages of labor and materials have restrained supply and higher home prices have reduced affordability.
FAVORABLE	THE DOLLAR	The dollar is likely to be stronger. Central bank policy is a key factor in the near-term currency outlook and the Fed should be more aggressive in tightening.
FAVORABLE	REST OF THE WORLD	A mixed bag. The spread of the virus, containment efforts, and the distribution of vaccines has varied widely.
NEUTRAL	LONG-TERM INTEREST RATES	Bond yields normally rise in an economic recovery, but yields are even lower abroad, adding downward pressure. While inflation is higher in the near term, we should see it move back down in the next year or so.
NEUTRAL	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.
UNFAVORABLE	INFLATION	Higher and persistent. Price increases have broadened in recent months. We ought to see some rollback in prices of consumer durable goods in 2022, but inflation in services (including rents) is more worrisome.
UNFAVORABLE	MONETARY POLICY	The Fed is expected to raise short-term interest rates by the middle of the year (perhaps sooner). The risk of a monetary policy error has increased.

Sector Snapshot

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

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

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

These recommendations will be displayed as such:

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

Equal Weight: expect in-line relative performance

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

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

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	CONSUMER DISCRETIONARY	12.6%	Consumer demand trends remain strong, and we are hopeful that supply chain issues and labor costs can ease over the next six to twelve months as COVID concerns abate. The recent Omicron variant may delay this improvement and lengthen supply challenges, but we would use weakness as an opportunity to accumulate favored stocks.
	FINANCIALS	10.7%	Interest rate movements remain a key influence on performance trends, and global Omicron concerns are providing downward pressure on the US 10-year Treasury yield for now. It is hard to know how long this will transpire, but we maintain our bias for rates to grind higher over the next year as the economic recovery progresses. Accompanied by the likelihood for improved loan growth, fundamental trends should remain solid. We see the potential for upside to current earnings estimates and valuation remains attractive.
	COMMUNICATION SERVICES	10.3%	After coming under pressure in the fall, the Communication Services sector has recovered some over the past month. Fundamental and technical trends remain favorable for several of the sector's largest constituents, and many of the others are bouncing from oversold conditions. As earnings estimates held firm through the volatility, valuation became more attractive, thus, we maintain our Overweight stance for now.
	INDUSTRIALS	7.7%	Industrials were attempting to build relative strength as Delta variant challenges showed signs of abating. However, the Omicron variant's spread is a renewed headwind for the sector. While this can continue for the short term, we remain positive on the intermediate-term fundamental backdrop as inventories get replenished from very low levels within an improving global manufacturing environment. We would use the current weakness as an opportunity to accumulate favored stocks.
	ENERGY	2.7%	Energy has pulled back recently with oil prices, as global demand is weighed on by the Omicron variant. While this volatility may persist in the short term, we believe that fundamental strength and substantial free cash flow (along with shareholder-friendly uses of this cash) remain supportive. Additionally, valuation is attractive with WTI crude at current levels in our view. We maintain our Overweight rating to Energy and would use the recent weakness as an opportunity to accumulate as needed.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	29.3%	Technology has been the market driver in recent months following a strong Q3 earnings season, and fundamental momentum (accelerated economic digitization) continues to be a tailwind for the sector. Additionally, Omicron concerns have weighed on global bond yields, supporting current elevated valuations. We continue to recommend a healthy allocation to Technology, and while relative strength may persist in the short term, we see the potential for greater upside in more recovery-oriented areas over the intermediate term.
	HEALTH CARE	13.2%	Aging demographics, along with increased consumer and governmental health care spending, bode well for fundamental trends. Additionally, valuation remains attractive. However, potential regulation (e.g., drug prices), along with relatively lower earnings growth in the recovery, support our Equal Weight recommendation.
	MATERIALS	2.5%	Earnings estimate revision trends and valuation remain attractive, but tough comps in 2022 and the appreciating US dollar are headwinds. Relative strength continues to trend sideways, supporting our Equal Weight stance.
	REAL ESTATE	2.7%	We continue to view Real Estate as a stock-picker's sector with opportunity for varying degrees of economic sensitivity to the recovery. Valuation is elevated relative to growth projections, but FFO estimate revision trends remain healthy and the Omicron variant is likely to put downward pressure on interest rates (positive for Real Estate). This may support relative strength in the short term, though we maintain an Equal Weight stance.

Continued on next page

UNDERWEIGHT	CONSUMER STAPLES	5.8%	Many companies are experiencing challenges with cost inflation and pricing power, leading to margin pressures. Performance has improved as of late, but intermediate-term relative strength trends remain downward, supporting our Underweight stance.
	UTILITIES	2.5%	The sector has held up well through the Omicron volatility, but intermediate-term relative strength trends remain downward. Slow earnings growth, weak estimate revision trends, and the potential for higher interest rates also contribute to our Underweight stance on this defensive sector.

Disclosure

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

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

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

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

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

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

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

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

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

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

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

The process of rebalancing may result in tax consequences.

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

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

The indexes are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities.

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

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

RAYMOND JAMES

FIRST Q. NAME / GROUP NAME
Approved Title

12345 Streetname Lane // Cityplace, ST 00000
T 000.000.0000 // M 000.000.0000 // F 000.000.0000
first.lastname@raymondjames.com // xyzwealthmanagementgroup.com

Investments & Wealth Institute™ (The Institute) is the owner of the certification marks "CIMA" and "Certified Investment Management Analyst." Use of CIMA and/or Certified Investment Management Analyst signifies that the user has successfully completed The Institute's initial and ongoing credentialing requirements for investment management professionals.

Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™, CFP® and CFP in the U.S., which it awards to individuals who successfully complete CFP Board's initial and ongoing certification requirements.
© 2022 Raymond James & Associates, Inc., member New York Stock Exchange/SIPC. 21-BDMKT-5235 AW/EG/BS 1/22