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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

Moving to the Next Stage

This year marks the 110th edition of the Tour de France, the most prestigious bicycle race in the world. And like the markets, the Tour is always challenging—and evolving. The three-week, grueling 2,200+ mile *route* changes every year and, surprisingly, starts in different countries—this year in Spain versus the UK, the Netherlands, Germany, Belgium, and Denmark over the previous five years! The point is, just like the Tour, economic and market cycles have different starting points, and no two routes are alike.

Just look at the economic course we are currently on: It began with a historic pandemic and has since snaked through near-record inflation, a war, assorted political tensions, and unprecedented fiscal and monetary policy changes. For investors, the trip has been as exhausting as climbing the iconic Col du Tourmalet in a brutal *mountain stage* this year. But, as we move to the next stage of our investment journey, the goal for cyclists and investors is the same: Be ready, adjust when necessary, and maintain a long-term perspective.

The US economy continues to *pedal* forward, defying predictions it would skid into a recession, thanks in part to the *'doping'* effects of unparalleled fiscal (i.e., the approximately $5 trillion pandemic-related government stimulus) and monetary stimulus (i.e., record-low interest rates and Federal Reserve (Fed) bond-buying program). Many cheered the robust labour markets, strong consumer spending and strong wage gains that resulted. Now we will see how the economy performs without artificial stimulus and on its own merits. Like Tour officials clamping down on 'dopers', the Fed is cracking down on inflation, tightening interest rates by 500 basis points (5%) over the last 15 months, boosting borrowing costs on everything from credit cards to autos. Today, with mountainous interest expenses and excess consumer savings evaporating quickly, consumers can no longer coast along. Understandably buyers are showing signs of fatigue. This, combined with credit tightening and job growth slowing, suggests the economy will slide into a mild recession beginning in the fourth quarter. Despite the slowdown, this year's fast start keeps overall 2023 GDP growth positive at 1.3%. But we do expect it to *decelerate* to between 0.5–0.7% in 2024.

Every cyclist's nightmare is a chain-reaction crash, and the Fed is trying to avoid a *pile-up* after its interest rate hikes. Banking turmoil in March may have been the Fed's *flamme rouge*: The red banner that tells cyclists they're close to the finish line. Restrictive rates seem to be doing their job—putting the *brakes* on the economy. There is no question that the economic data (slowing inflation, rising jobless claims and below-trend growth) are moving in the direction the Fed wants, it's just not happening at the *pace* it wants. The big question is how much patience the Fed must have to allow the disinflationary trend to continue before tightening further. Ultimately, we believe the Fed is in the latter stages, if not near the end, of its tightening cycle. We expect the federal funds rate to end the year at 5.50%. However, as the economy shifts down a gear in 2024 and the unemployment rate nears 5%, expect the Fed to cut the fed funds rate to 4.0%.

In fixed income, with Fed tightening nearing the end, inflation decelerating down, and the economy no longer *'pumped up'* by stimulus, Treasury yields are poised for a *downhill glide*. In fact, we expect the 10-year Treasury yield to reach 3.25% by year end. In cycling, the downhills can be dangerous, and in an environment where growth will be dicey, we prefer to play it safe and focus on high-quality bonds. We recommend Treasurys, investment grade and municipal bonds. They combine healthy coupon yields with an opportunity for capital gains if yields decline. The yield curve is likely to remain inverted—short-term yields higher than long-term yields—until the Fed starts easing. Therefore, it's prudent for investors to balance their bond maturity exposure and lock in some longer maturity yields before they move lower.

Despite market expectations for treacherous *terrain*, our positive equity market outlook entering 2023 paid off: Double-digit gains by the S&P 500 are pushing it near our year-end target of 4,400 and potentially toward our 12-month target of 4,600. The good news is the equity market has technically transitioned into a bull market (up more than 20% from last October's lows). The bad news is we've probably entered a new, more volatile stage. We based our early optimism on unwarranted skepticism and pessimism in the markets. Our view proved prescient: Earnings came in better than expected, inflation is decelerating, the US government didn't default, and the Fed will probably dial back its interest rate hikes. Moving forward, our upside view is tempered; we see potential *blind curves* ahead. For example, the recent surge in investor optimism may set the market up for disappointment. But in the long term, healthy macro *tailwinds*, a 2023 earnings per share (EPS) target on track at $215, a broadening of sector participation, and history keep us optimistic. And there's more potential upside if the Fed pulls off a soft, non-recessionary landing.

The *breakaway* leader of the pack in this equity rally has been the Tech sector, earning the coveted *Yellow Jersey* (best overall performance) with its fastest start to a year in more than three decades. Recently, artificial intelligence (AI) headlines have even given those stocks a second wind to bolster their lead. The question now is whether Tech can sustain its lead or whether other parts of the equity *peloton* will catch up. While we believe Tech will continue to advance, we expect other market sectors will close the gap as time goes on.

Within US sectors, we expect Health Care to earn the polka dot *King of the Mountains Jersey* (best climber). Health Care should navigate expected increased volatility and benefit from its attractive valuations, defensive characteristics, and consistently robust revenue growth. The *Green Jersey* (best sprinter) competition will feature an uphill battle between the Financial and Energy sectors—both of which have fallen well behind year-to-date. These two sectors will quicken their pace if oil prices climb higher (benefits the Energy sector if oil reaches our year-end target of $85/barrel) or if the Fed ends its tightening cycle (benefits the Financial sector). For the *White Jersey* (best rider under 25), we turn to the emerging markets. Look for the long-awaited rebound in the Chinese economy, lifted by more aggressive stimulative policies, to boost Asian economies. India is emerging as a potential strong *all-rounder* on the world stage, with recent adjustments to supply chains that could benefit India-US ties. Expectations for higher oil prices, continued manufacturing 'nearshoring' (away from China), and easing monetary policy should support Latin American equities.

The Tour de France includes 21 stages over 23 days—varying from flat (6), hilly (6), mountains (8) and one individual *time trial*. While individual riders may win different stages of the course, the overall winner is the rider with the lowest *cumulative time*. In fact, three-time US winner Greg LeMond won the race in 1990 without winning a single stage. A balanced, well-rounded, and consistent long-term-focused strategy is essential—as it is for successful investors! Remember that while individual cyclists get the headlines, the race is a team sport. Up to 100 team staff members ensure cyclists get water, food, equipment, and support. Don't go the distance alone. Reach out to your financial advisor for guidance to help you get to the finish line of your financial goals. And hopefully, like most Tours, you will have enough of a lead in obtaining your investment goals so that the last few miles are a leisurely procession all the way to the Champs-Élysées!

Enjoy your summer!

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

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Long-term Inflation: Will the Fed Get to 2% or Will it Change the Target?

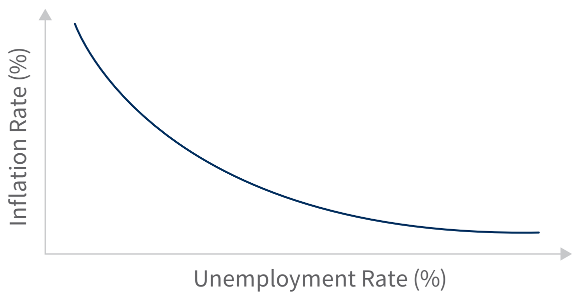
Eugenio J. Alemán, PhD, *Chief Economist,* Raymond James
Giampiero Fuentes, *Economist,* Raymond James

UK Editor comments: The question is sometimes asked, why should the world's developed economy central banks, instead of raising interest rates so aggressively, not simply raise the inflation target instead? Here our US economists address the issue, focusing mainly on the Federal Reserve, but the same analysis pertains both to the Bank of England and the European Central Bank.

Inflation targeting was pioneered by New Zealand in the late 1980s as the country underwent significant economic and financial market reforms. The primary goal was to maintain price stability by targeting inflation between zero and two percent, with the range allowing the country's Reserve Bank (its central bank) to accommodate volatility and external shocks. However, despite the flexibility, the Reserve Bank ultimately changed its targeting goal to two percent, providing more clarity to the public and policymakers. This experience with inflation targeting influenced central banks worldwide, including the Bank of England, which adopted a two percentage point target in 2003 and the Federal Reserve, which declared similar target in 2012.

The Federal Reserve (Fed) estimates that two percent for the Personal Consumption Expenditure (PCE) price index over the long run is the most favourable rate of inflation to support one of the institution's dual mandates: price stability. The second mandate is to keep the rate of unemployment as low as possible. But the biggest issue for the Fed, as with central banks elsewhere, is that in general, and over history, there has been an

Phillips Curve



inverse relationship between the rate of inflation and employment. If employment is too strong, that is, if the rate of unemployment is too low, the rate of inflation would tend to increase, and vice versa. This is what is normally called the Phillips Curve.

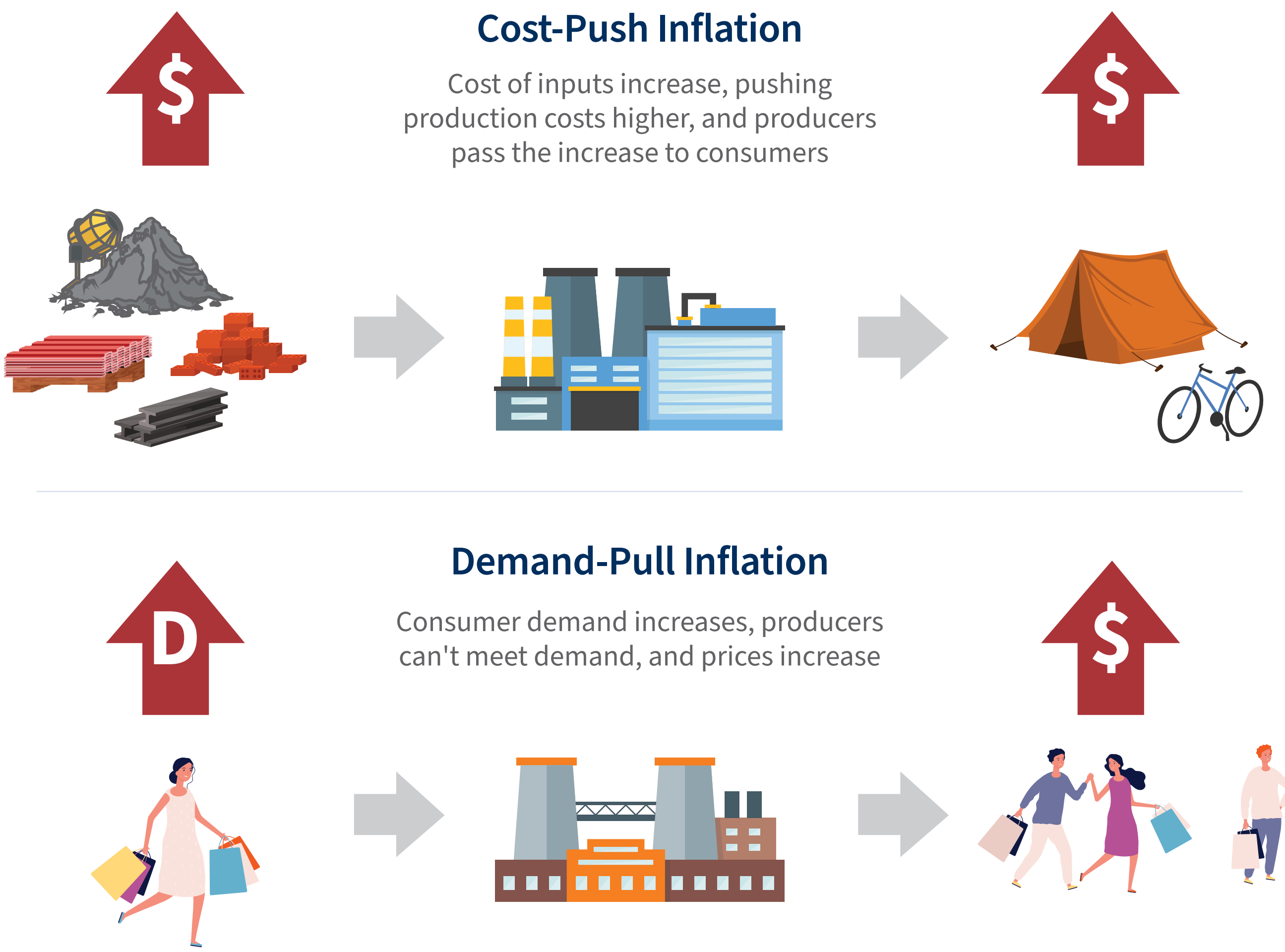
But this relationship has broken down over the last several decades. During the pre-COVID-19 pandemic years, developed economies were able to keep inflation under the 2% target while at the same time keeping the rate of unemployment at uncharacteristically low levels compared to the historical Phillips Curve relationship. Thus, the question for central banks today (excepting the Bank of Japan) today is whether we will go back to a pre-pandemic relationship between inflation and unemployment or if the Phillips Curve relationship will once again apply.

Inflation occurs when there is a generalised increase in the level of prices in an economy. There are, in principle, two processes by which inflation occurs. The first one is called 'cost-push inflation,' which occurs when there is an increase in the cost of production in an economy; that is, when the aggregate supply curve shifts to the left. The second one is called 'demand-pull inflation,' which occurs when the aggregate demand curve shifts to the right.

Inflation occurs when there is a generalised increase in the level of prices in an economy.

The issues that occurred during the COVID-19 pandemic, like the reduction in production due to the closing down of economies, plus the supply chain issues are part of the cost-push inflation argument. That is, as the supply of goods decreases (i.e., the supply curve shifts to the left) the price of the goods/services affected increases, if other things stay constant. In the second process, which is called demand-pull inflation, the demand for goods increases (i.e., the demand curve shifts to the right) and this pushes prices higher, other things constant. This process occurs if there is anything happening in the economy that shifts the demand for goods (and/or services) to the right. In this case, what happened was that the US and other Western governments transferred large amounts of income to individuals and businesses to help them survive the pandemic, and this shifted the demand curve to the right.

In fact, what happened during the COVID-19 pandemic, both in terms of 'cost-push inflation' as well as 'demand-pull inflation,'



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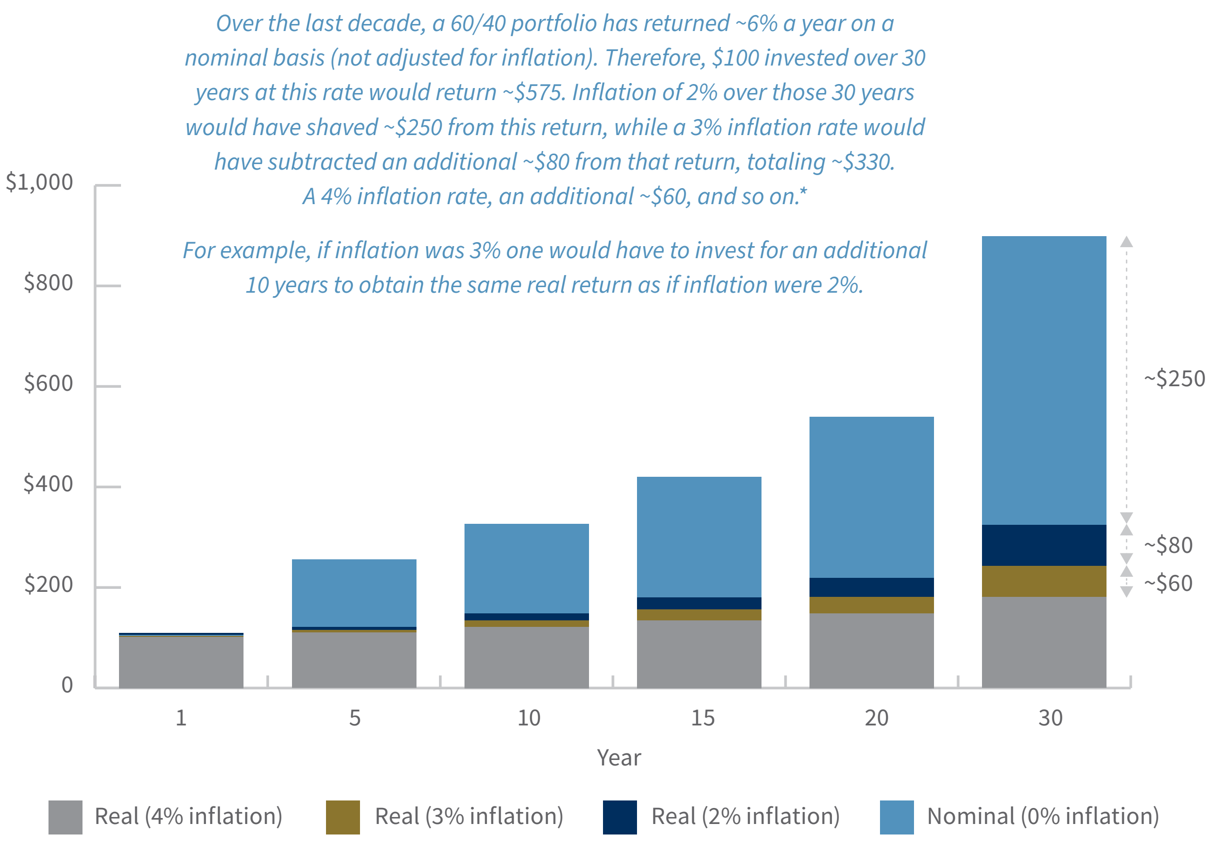
could be considered a perfect storm for inflationary pressures, and central banks were slow to react. High inflation hasn't been a concern since the 1980s as inflation has averaged approximately 3%, and over the last decade, all central banks have been undershooting their inflation targets. In fact, the rate of inflation from the end of the Great Financial Crisis until the beginning of the pandemic in 2020 has been ~1.8%. While it is hard to precisely explain what has kept inflation so low, especially while employment has remained healthy, we believe that one of the potential partial reasons has been, in the case of the US economy, the strength of the dollar and more generally, globalisation. Additionally, the increased strength of the US dollar over the last decade made imports more affordable to that economy. Technological advances have also likely had an impact on inflation, not only due to the ability of companies to outsource labour but also due to the ability of consumers to quickly discover and compare competitor prices.

What happened during the COVID-19 pandemic, both in terms of 'cost-push inflation' as well as 'demand-pull inflation,' could be considered a perfect storm for inflationary pressures, and the Fed was slow to react.

THIS TIME IS NO DIFFERENT

Over the last two years, inflation has increased to the highest level in forty years mostly due to consequences of the pandemic, including product shortages, supply chain disruptions, highly expansive fiscal policies, and strong consumer demand. However, once all of the above returns to somewhat normal levels, inflation should return to long-term target levels. Perhaps the biggest issue in the US and the UK is that to do with immigration, which was severely curtailed due to COVID-19 and Brexit, but has

The Impact of Inflation on the Return of a 60/40 Portfolio



*This is a hypothetical example for illustrative purposes only. Past performance may not be indicative of future results. There is no assurance these trends will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs which would reduce an investor's return. The 60/40 Portfolio was 60% invested in the S&P 500 Index and 40% in the Bloomberg Barclays U.S. Aggregate Bond Index. The S&P 500 is an unmanaged index of 500 widely held securities. The Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market. An investor cannot invest directly in these indexes.

returned to somewhat normal levels over the last year or so. On the other hand, technology continues to advance driving corporate costs lower. Lastly, although the labour force participation rate collapsed during the COVID-19 pandemic, the recent improvement will help normalise the labour market going forward.

In any case, even if the conditions that existed before the pandemic are no longer extant, we believe there is a zero probability that the Fed, or any other systemic central bank will change the target rate of inflation at this time because there are analysts saying that the Fed cannot achieve the current target rate of inflation! First of all, the target rate of inflation is a target. That is, central banks are going to conduct monetary policy to bring the rate of inflation to the target rate, period, regardless of what any analyst believes. Second, before the COVID-19 pandemic recession, a 3.5% unemployment rate was consistent with a 2% inflation target. However, this may not be true today and monetary policy may have to be adjusted to allow for a higher rate of unemployment in order to achieve the target rate of inflation of 2%. Third, if after achieving 2% inflation over several years, central banks decide that something different than 2% for the average inflation rate over the years is better than the current rate target, then they may decide to change it. However, this decision will be completely independent of one that says that the 2% target cannot be attained. The Fed and other developed economy central banks will change the target if they believe that a different target is better for the economy than the target prevailing today, not because they cannot achieve that target.

Furthermore, central banks strive to have well-anchored inflation expectations at two percent over the long run because if consumers and businesses expect stable prices, they can ultimately make sound decisions about their spending, saving, and investments. Similarly, stable inflation expectations lower wage pressures coming from workers. Overall, a two percent rate of inflation is still comfortable, manageable, and most importantly, sustainable, for both consumers and employers over the long run. Additionally, many retirement plans are based on the assumption that inflation will be 2% over the long run, and higher levels of inflation would compound over time and ultimately have severe impacts long term.

THE BOTTOM LINE:

The rate of inflation, after remaining below central banks' 2% target for several years, has remained above target due to the severe COVID-19 pandemic shock and its policy aftermaths. Although the central banks were caught off guard and reacted tardily to its inflationary impacts, the disinflationary process started in July of 2022 and has continued ever since.

It is true that inflation has remained above target for more than two years and thus it will take a longer time to bring down, however, the process is guaranteed by the commitment to achieving its 2% target over the years and thus, there is nothing— other than sticking to the target—that needs to be done to achieve that target.

Using the words used by the Federal Reserve on its website when answering the question "Why does the Federal Reserve aim for inflation of 2 percent over the longer run?" and adapting it to today's environment, we conclude that:

"Following periods when inflation has been running persistently above 2 percent, appropriate monetary policy will likely aim to achieve inflation modestly below 2 percent for some time. By seeking inflation that averages 2 percent over time, the central bank's rate-setting Committee will help to ensure longer-run inflation expectations remain well anchored at 2 percent."

KEY TAKEAWAYS:

- The Federal Reserve estimates that two percent for the Personal Consumption Expenditure (PCE) price index over the long run is the most favourable rate of inflation to support one of that institution's dual mandates: price stability. The Fed's second mandate is to keep the rate of unemployment as low as possible. The Bank of England and European Central Bank primary mandate is to drive down inflation above all else.
- Over time, there has been an inverse relationship between the rate of inflation and employment. If the rate of unemployment is too low, the rate of inflation would tend to increase, and vice versa. This is known as the Phillips Curve. But this relationship has broken down and a question for the Fed central banks is whether the Phillips Curve will once again apply.
- Inflation occurs when there is a generalised increase in the level of prices in an economy. There are two ways in which inflation occurs, 'cost-push inflation,' which occurs when there is an increase in the cost of production in an economy, and 'demand-pull inflation,' which is when the demand for goods increases.
- Inflation has increased to the highest level in forty years mostly due to consequences of the pandemic, including product shortages, supply chain disruptions, highly expansive fiscal policy, and strong consumer demand. Once these things normalise, inflation should return to the long-term target.
- The world's most important central banks are going to conduct monetary policy to reach the target rate of inflation. They are not going to change that target.

India: Is Geography Destiny?

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

On 14 March of this year the United Nations formally acknowledged that India had overtaken China to become the most populous nation on the planet. In truth, such is the nature of census gathering that the exact timing may have happened somewhat earlier, but the broader point is that possibly as soon as 2024 India will be the home of the world's largest pool of labour. Why does this matter and what might the implication be for investors seeking to augment portfolio performance with greater geographical diversity? Beyond that, how should investors feel regarding the country's studied lack of alignment in a fractured world? And what to make of the political dimension with important elections scheduled for April/ May next year? Narendra Modi, leader of the ruling Bharatiya Janata Party (BJP), has proved the driving force behind a far-reaching reform programme which promises much, but he has many critics amongst his political opposition. Any analysis of India's attraction as an investment destination must take on board the often overlapping and regularly conflicting strengths, weaknesses, threats, and opportunities associated with a sprawling and diverse economy.

STRIKING GEOPOLITICAL BALANCE

Since gaining its independence from Britain in 1947 India has fostered a studiedly unaligned position on the world's stage, a position now under close scrutiny given tensions between the United States and its NATO allies and both Russia and China. Since the onset of the Ukraine war India has steadfastly refused to join the Western sanctions programme and has been steadily increasing its oil imports from Russia, taking advantage of substantial price discounts in so doing. Beyond that, Indian delegates actively debated the establishment of a free trade agreement with Russian counterparts at a bilateral conference in April.

But while its relationship with Russia may be discomforting to the West, India's position with regard to China is much less friendly. Despite being a key member of the so-called BRICS+ group, India has a shared security interest with the United States in limiting China's power and influence. Beyond that, periodic military confrontation along the shared border serve to illustrate that the two countries harbour profound differences both to one another and in their approach to the wider world.

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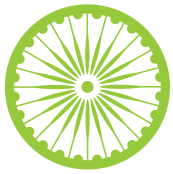
KEY GROWTH FACTORS

Young and rapidly growing working-class population

Growth in the manufacturing sector because of rising education and engineering skill level



Sustained growth of the consumer market driven by a rapidly growing middle class

Source: John Hawksworth and Anmol Tawari January 2011 – The World in 2050: The Accelerating Shift of Global Economic Power: Challenges and Opportunities PricewaterhouseCoopers

In a fractured global economy, one in which the global geopolitical and geoeconomic map is being swiftly redrawn, it remains to be seen how long India can remain on the fence. Despite periodically sharing the same stage, India's leadership is deeply mistrustful of China's overseas adventurism. Diplomatic relations between New Delhi and Beijing are arguably even more strained than are the latter's with Washington DC. This has manifested in steps already underway to reduce China's economic leverage in India, taking a hard line on Chinese apps and joining the US in banning Huawei and ZTE equipment for 5G networks.

Furthermore, India's position to benefit from the so-called 'friend-shoring' of manufacturing supply chains has been exemplified by April's high-profile meeting between Mr. Modi and Apple CEO Tim Cook. Albeit starting from a low base, iPhone production has tripled in India over the 12 months to March and a further strengthening of commercial relationships across a range of manufacturing activities seems highly likely.

This strengthening and broadening of commercial relationships has, at its heart, a clear understanding on India's part that its best interests are likely served by building closer ties with the US. Most notably, the US is much more economically significant to India than is China. Export volumes and values to the US are already much greater, as is direct investment into the subcontinent. In essence, what is being envisaged is the creation of a manufacturing ecosystem of multiconnective activities, a network of short supply chains the benefits of which would likely attract other multinational corporations to participate. Were what is envisaged to come to fruition, the foundations would be laid for a local manufacturing sector so competitive as to allow India to achieve growth rates akin to if not greater than the best performing emerging economies over the past few decades.

> In a fractured global economy ... it remains to be seen how long India can remain on the fence.

STRUCTURAL REFORM

Key to unlocking this undoubted potential is harnessing and focusing the hitherto latent power of the Indian workforce. The demographic dividend lies in unleashing the population into a globally competitive and, initially at least, a labour-intensive manufacturing sector. This is nothing new, the path to economic prosperity is characterised by boosting the productivity of previously low and unskilled workers through migration from an agrarian and (particularly in India's case, low-end services) into highly mechanised factories. History shows only too clearly that this migration delivers labour productivity far greater in its early stages than does the service sector.

More important still is the potential associated with bringing women into formal work. As it stands female participation in the workforce amounts to just 20% according to World Bank data, extremely low relative to other equally deeply conservative countries including Saudi Arabia. Admittedly, the World Bank's conclusion may be misrepresentative as it likely does not take into account the large proportion of women engaged in very low skilled household activities. Be that as it may, the broader point is that until now Indian women have historically found it impossible to escape low productivity informal work.

Going forward, the evolution of India's manufacturing sector will provide the gateway for Indian women formally to enter the workforce for the first time. The benefits associated with so doing are already clearly apparent elsewhere in Asia including Vietnam and neighbouring Bangladesh. The creation of 'all-female' factories should serve to overcome deeply entrenched conservatism and an ancient caste system increasingly viewed as holding the economy back.

THE POLITICAL DIMENSION

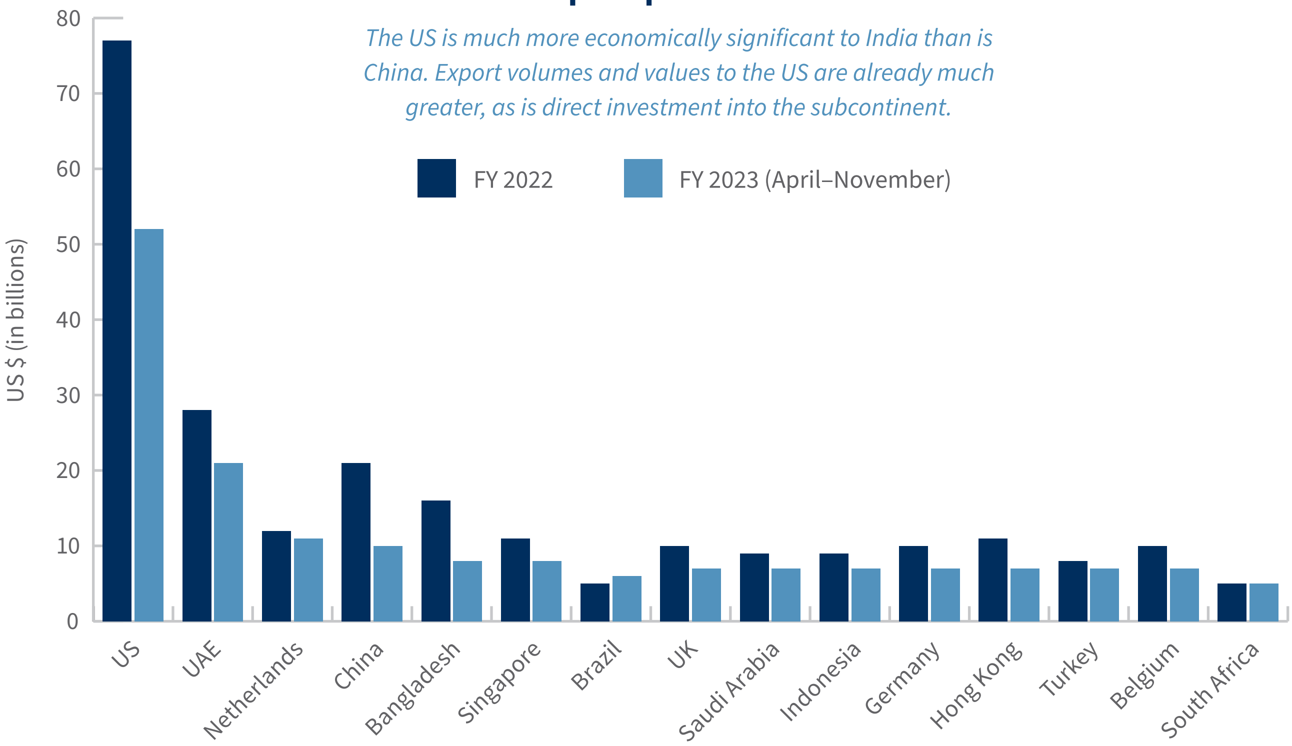
If this potential is to be unlocked, the political determination and drive to achieve it must be maintained. India's political cycle is turning and the season ahead of 2024 elections is fast approaching. In the previous parliamentary election, in 2019, Prime Minister Modi's BJP Party won 303 seats out of 543 in the Lok Sabha (lower house), a substantial majority by the standards of the recent past and with it a strong mandate to push through reforms. Importantly, the run-up to the campaigning season has seen the main opposition Congress Party take control of the state of Karnataka on 10 May, causing political scientists to assess the possibility of an electoral upheaval and prior to that the possibility that the pace of reform might be dialed back as the ruling BJP seeks to preserve its majority.

At present it is thought likely that the BJP will win the forthcoming election, but with a reduced majority of around 270 seats. The Karnataka election result, whilst a setback, likely reflects the fact that local issues tend to assume preeminence, not issues of strategic national significance. History reveals that Karnataka has not elected an incumbent government of either leading party since 1985. More encouragingly, the majority of the population recognise and have benefited from reforms undertaken thus far. Infrastructure improvements are important to this, but not so central as the overhaul of the country's welfare programmes through the rollout of technological improvements. The improved speed, efficiency and reliability of welfare distribution explains why BJP support, historically located in the business and trading communities, has spread across the urban poor and rural constituencies. Other life-transforming programmes, particularly those associated with sanitation, are also proving popular.

Where Modi may encounter opposition is the perception that his party has exploited ethnic divisions within the country, emphasising a 'Hindu first' agenda deeply unpopular with the country's Muslim population. This is not to be belittled, but neither is the widespread surge in popular aspiration since. Modi was first elected in 2014, manifest in a growing awareness of the country's significance on the world stage.

India's Top Export Destinations

The US is much more economically significant to India than is China. Export volumes and values to the US are already much greater, as is direct investment into the subcontinent.



Source: India Ministry of Commerce

> “ Going forward, the evolution of India’s manufacturing sector will provide the gateway for Indian women formally to enter the workforce for the first time. ”

RUPEE TO STRENGTHEN ON THE FOREIGN EXCHANGE

Typically, long-term exchange rate projections are based upon significant structural determinants, in particular perceptions regarding relative productivity growth, commodity terms of trade and inflation. The above analysis illustrates the productivity potential still to be unlocked. Beyond which India’s commodity terms of trade will drive an appreciation in the rupee’s relationship with the dollar. History shows clearly that the Indian currency’s trade weighted relationship with the dollar has trended higher during periods of rapid productivity growth, particularly during the 1990s. Combine this with the forecast that domestic inflationary pressure will fall faster relative to inflation in the United States points to an appreciation in the rupee over the next decade or so in both nominal and real terms.

"Geography is destiny" is a term first coined by Arab sociologist and philosopher Ibn Khaldan in the Middle Ages, and as it applies to modern geopolitics it remains hotly debated. Where a country stands in relation to wide-ranging issues depends, to a large extent, on where it sits. What is clearly apparent is that an increasingly self-assured India recognises its position in the world and is prepared both to unlock and to harness its economic potential. As the geopolitical map is redrawn new geoeconomic relationships are being forged. India has a pivotal role to play in this transformation.

KEY TAKEAWAYS:

- India has overtaken China as the most populous nation in the world.
- India has a shared security interest with the United States in limiting China’s power and influence.
- There is a clear understanding on India’s part that its best interests are likely served by building closer ties with the US.
- What is clearly apparent is that an increasingly self-assured India recognises its position in the world and is prepared both to unlock and to harness its economic potential.

The End of Globalisation? Risks and Opportunities of a New Economic Era

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

Are the US and Chinese economies decoupling, or are we seeing a more strategic approach to national security priorities and supply chain resiliency? The answer to this question depends upon the policy decisions over the next several years and could have massive implications for the global economy and equity market. We are of the view that a broad-scale decoupling and the formation of regional economic blocs is less likely, but a trend of reindustrialisation and de-risking will be a market theme that investors will navigate in the years ahead. We also argue that recent US policy decisions are the foundation for an industrial renaissance aimed at building up the economic base of the country and protecting it against some of the geopolitical and supply chain risks that have had significant impacts in recent years—most acutely felt during the COVID supply chain shortages of critical materials. Key aspects of this industrial renaissance are a series of 'carrots' in the form of tax subsidies and direct support vs. the initial phase of 'sticks' in the form of tariffs, blacklistings, and tech restrictions.

A trend of reindustrialisation and de-risking will be a market theme that investors will navigate in the years ahead.

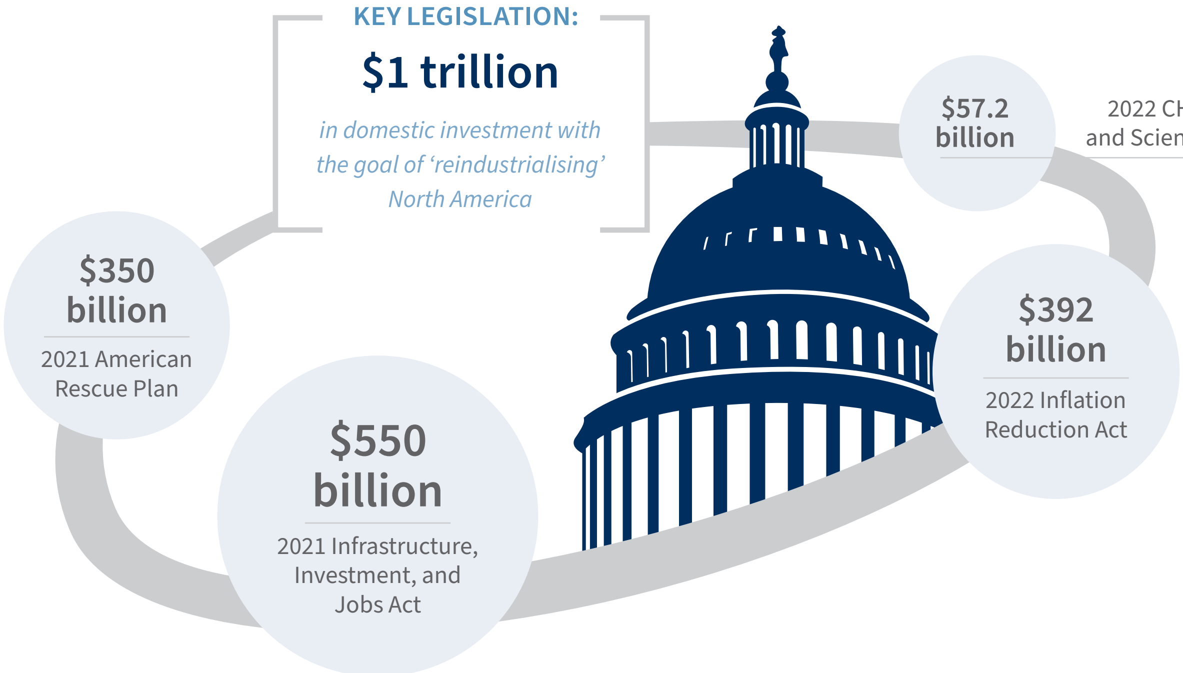
US AND CHINA AT A CROSSROADS: A SHIFT IN THE GLOBAL ECONOMIC ORDER

Concern over China's longer-term geopolitical ambitions and the threat posed by that country's military to the US and key allies has been a major focus of US policy in recent years. During the Trump Administration, concerns about China's unequal market access and intellectual property theft led to a 2018 'trade war' with tariffs levied against a broad set of China's imports into the United States. A key concern was that US technology that was traditionally used for civil use could be repurposed and used to further military ambitions. This led to US policy viewing technology as a national security asset, leading to new export restrictions and blacklisting various Chinese companies from receiving access to US technology, especially in the semiconductor space. The flow of US capital into critical sectors in China that finance the country's economic competition with the US also came under enhanced scrutiny. While this economic confrontation was initially driven by national security considerations, the COVID-19 pandemic exposed additional vulnerabilities around global supply chains, particularly with technology components and medical goods that drove shortages and spiked prices. These conditions set the stage for a rethinking of US-China economic relations that quickly became a bipartisan consensus in Washington.

GOVERNMENT RESPONSE: SECURING SUPPLY CHAINS & INVESTING IN THE DOMESTIC INDUSTRIAL BASE

In response to the dynamics outlined above, the US government has enacted policies with both 'sticks' and 'carrots' that create challenges and opportunities for investors navigating the shifting global environment. Export controls, tariffs, and economic restrictions through the blacklisting of certain companies have created revenue and cost challenges for US companies with significant exposure to China's market. Frequently, these policies are announced with little warning and carry high impact—raising headline risk for exposed sectors. However, policymakers have also unleashed more than $1 trillion in domestic investment across pandemic relief measures and new funding for domestic infrastructure, semiconductor manufacturing, and the energy transition. Key legislation on this front includes the 2021 American Rescue Plan ($350 billion in funding for infrastructure), the 2021 Infrastructure, Investment, and Jobs Act ($550 billion), the 2022 CHIPS and Science Act ($52.7 billion), and the 2022 Inflation Reduction Act ($392 billion). These new policies direct federal funds and catalyse private sector investment toward what we refer to as the 'reindustrialisation' of North America. In combination, the goal of these policies is to fortify the US domestic industrial base and limit future economic dependencies that can drive economic disruptions or be used against the US as economic leverage. Even with this level of new investment, we still see significant appetite in Washington to build on and supercharge certain aspects of the domestic economic agenda. Permitting reforms, investments in critical minerals, and preserving a role for legacy energy to limit transition risks all contribute to economic growth prospects over the years ahead. The global impacts of the war in Ukraine add a national security imperative around these goals. Vulnerabilities experienced by countries with oil and gas dependencies following Russia's invasion of Ukraine have prioritised projects that build out legacy energy infrastructure and limit potential vulnerabilities around critical minerals as the energy transition gains pace. In this sense, policymakers are wary of replacing dependence in the oil and gas space for critical mineral dependencies with supply chains heavily concentrated in China. Overall, the events of the last several years have placed national security and economic disruption concerns as leading drivers of policymaking in Washington.

> Permitting reforms, investments in critical minerals, and preserving a role for legacy energy to limit transition risks all contribute to economic growth prospects over the years ahead.



> “Overall, the events of the last several years have placed national security and economic disruption concerns as leading drivers of policymaking in Washington.”

As markets digest the impact of this trend, we see clear winners and losers from an investment perspective. As federal funding is deployed and the reindustrialisation theme plays out, we expect Industrials to be a clear beneficiary. New investment and market opportunities for the energy transition will be a material boost for clean energy equities. We see the transition as balanced across the energy space with permitting reform boosting the buildout of energy infrastructure and increasing demand for liquified natural gas (LNG). In terms of potential headwinds, the Technology sector will be a space that is exposed to risks as the policy impact unfolds. Emerging technologies such as artificial intelligence (AI), quantum computing, and robotics will be in the crosshairs of new controls and regulations which can limit the ability of certain companies to scale and penetrate China's market. Biotechnology and pharmaceuticals are other areas to watch which could see similar controls in the future. In all, we expect material market impacts over the coming years as this economic transition takes shape.

WHAT'S NEXT

Investors should be aware of critical trends that will impact the evolution of this emerging theme. First, China's response can increase market risks if US policy actions are seen less as 'de-risking' and more as 'decoupling' by another name. US companies could be targeted as retaliatory steps, which could raise overall US-China tensions. The fate of Taiwan and the outcome of its presidential elections in January 2024 will also be important to monitor. While the Biden administration is taking steps to de-escalate tensions around the question of Taiwan's status, China perceiving Taiwan as moving closer to independence could accelerate the timeline for a regional conflict that could drive global economic disruption on a significant scale. Lastly, the inflationary impact of a shifting global economic order will have important consequences for the direction of monetary policy. Higher costs and elevated spending could weaken the Federal Reserve's tools to fight inflation and prolong high interest rates—a 'higher for longer' scenario. We expect attention to increase on these issues over the next year, especially as the US prepares for the 2024 presidential election campaign that will help determine the trajectory of a changing macro investment environment.

KEY TAKEAWAYS:

- We are of the view that a trend of reindustrialisation and de-risking will be a market theme that investors will navigate in the years ahead.
- Recent policy decisions are the foundation for an industrial renaissance aimed at building up the US economic base and protecting it against some of the geopolitical and supply chain risks that have had significant impacts in recent years.
- Concern over China's longer-term geopolitical ambitions and the threat posed by China's military to the US and key allies has been a major focus of US policy in recent years, leading to that policy viewing technology as a national security asset.
- The US government has enacted policies with both 'sticks' and 'carrots' that create challenges and opportunities for investors navigating the shifting global environment.
- We expect material market impacts over the coming years as this economic transition takes shape.

Why Have UK Government Bonds Performed So Poorly?

Professor Jeremy Batstone-Carr, *European Strategist,*
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This has been a difficult twelve months for investors in the UK's gilt-edged market. Problems began in the early autumn of 2022 at the commencement of the short-lived administration of Elizabeth (Liz) Truss and in particular an unfunded mini-Budget presented by the then Chancellor of the Exchequer, Kwasi Kwarteng. As the wings of crisis beat about the UK economy, manifest on the foreign exchanges as much as the sovereign bond market, desperate times required desperate measures. The Truss-led administration was swiftly replaced, Mr Rishi Sunak assuming the Prime Minister's mantel and Mr Jeremy Hunt the role of Chancellor. Financial markets breathed a sigh of relief as steady hands took control of the tiller, while the Bank of England stepped in to provide emergency support. So sharp had been the bond sell-off that the market looked a prime target for investors seeking stability against the backdrop of a flagging economy. But after enjoying a brief renaissance the gilt-edged market has sold off again, the benchmark 10-year gilt-edged yield now back at the levels of last September while bonds of a two-year duration have seen yields surpass those mini-Budget highs. Why is this happening?

Perhaps the first point to make is that the UK sovereign bond market is not suffering alone. US Treasury and German bund stock have also witnessed rising yields despite persistent fears regarding the health of Western economies generally. A large part of the justification for the markets' weakness lies in the persistence of inflationary pressures and the aggressive approach to monetary policy setting deployed by the world's most important central banks. But while developed markets have been characterised by rising yields (falling prices at which bonds trade), the UK's gilt-edged market has endured by far the toughest time. This is reflected in the fact that the gap between the UK's 10-year gilt-edged yield and its US benchmark counterpart is now at its widest level since 2009 while that with the German equivalent is back to levels last seen in 1992.

While the UK economy has surprised many by its ability to withstand the lagging effect of high inflation, rising interest rates and the banking sector's steady withdrawal of credit to both household and business borrowers, and its oversight drawn praise from international organisations such as the IMF and OECD, it remains very much to be seen as to whether this resilience can be sustained.

One can hardly pick up a newspaper or turn on the radio or television these days without being assailed by a battery of stories of seemingly unending hardship, most latterly the consequence of the sharp increase in mortgage refinance costs. This is a direct consequence of the Bank of England's single-minded desire aggressively to pursue its primary objective, raising interest rates to drive down inflationary pressure at all costs, even if that means forcing a recession.

Although the Bank insists that price pressures will diminish over time, there's scant evidence of that happening in Britain. Yes, inflation is on a clearly decelerating trajectory elsewhere, most notably in the United States, but also in China where the year-on-year rate of price increases stands a little over zero and in Europe as the region's energy supply shock fades. What makes the UK experience so unique? There are two reasons; firstly, energy price inflation has fallen only very slowly, much more so than in the eurozone and thanks to the impact of the UK energy regulator's price mechanism. Secondly, and much more concerningly for those with responsibility for monetary policy oversight, the UK's underlying inflation (excluding the impact of fuel, food, beverages and tobacco) has not only proved more

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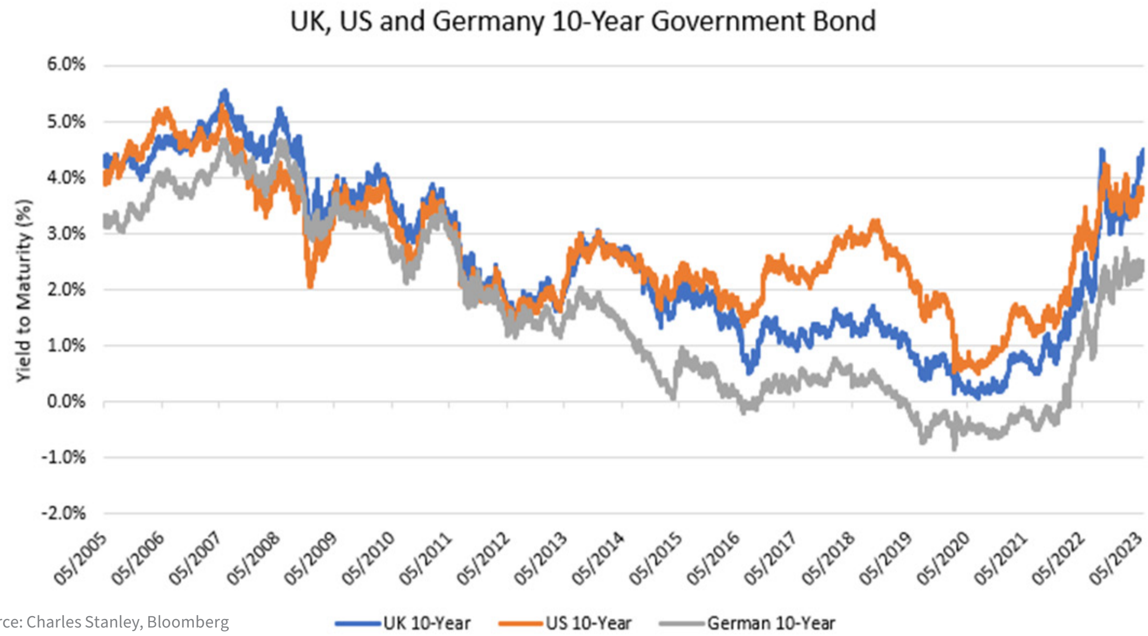

Source: Charles Stanley, Bloomberg

"sticky" than elsewhere, it has actually accelerated to a new 31-year high. The justification for this lies, so senior Bank of England officials believe, in the extent to which inflation expectations are now clearly showing up in wage growth. Annual growth in wages has hit 7.2% in the UK, in contrast with 5.2% in the eurozone and 4.3% in the United States. In both latter cases a steadily declining. So UK interest rates have risen and may rise again. In the money markets speculators are betting that a 5% base rate will not be the end of it, with 6% now firmly in the crosshairs.

The way all this relates to the gilt-edged market is through a steady rise in "real" (inflation adjusted) yields. It is clear that investors anticipate both that high inflation will be sustained and that in consequence the bank's monetary policy stance will have to be higher for longer. But are investors in the UK bond market being too cautious? It is sometimes said that the stock market is populated with optimists and the bond market by pessimists! In the US it is notable that the 10-year benchmark yield has risen only half as far as its UK counterpart. While local issues may account for some of that, the more general point is that investors in that country increasingly believe that higher US interest rates will be effective in forcing inflation down. In Europe, the German "real" yield has risen by even less, revealing even greater confidence in the policy effectiveness of the European Central Bank.

Whilst the UK economy does display notable variance to that of the US or eurozone, we think it likely that the eventual outcome of the Bank of England's monetary policy setting will be the same as elsewhere, economic weakness and inflation deceleration. Indeed, in a year's time the latter is thought likely to be pronounced, paving the way for lower interest rates and lower yields in the gilt-edged market. If anything financial markets, which like to get their worrying in early, are actually underestimating the extent of the eventual fall, a happy ending for investors in what has, up until now, proved a very uncomfortable story.

KEY TAKEAWAYS:

- After a difficult year, characterised by pronounced volatility, gilt-edged prices are lower and yields higher, back to and even above the levels of last September and the short-lived administration of Elizabeth (Liz) Truss.
- The UK sovereign bond market has not suffered alone, global bond markets responding to "sticky" inflation and higher interest rates.
- The UK economy has proved resilient up until now, but that may not last as higher interest rates impart downward pressure on activity.
- Inflationary pressures are taking longer to subdue than elsewhere, reflected in market pricing. But investors may be being too pessimistic, underestimating the scope for prices to rise and yields to fall going forward.
- The gilt-edged market provides both useful portfolio diversification and a typically more stable offset to more volatile stocks.

Stock Market Divergence Then And Now

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One of the underlying principles of investment, perhaps *the* underlying principle, is that portfolio diversification reduces risk. True, a properly diversified portfolio may limit future returns as ebbing and flowing tides do not lift all boats at the same time, the rewards varying by geographic location and by asset class but intrinsic within the investing process is the fact that when dealing with something as uncertain as the future, risk will always and for ever be the unshakable accompaniment. And risks come in many forms, from the systematic, those affecting financial assets generally, to those that are more specific or idiosyncratic in nature which impact more directly on individual assets. Much work goes into the identification and quantification of risk and in assessing an investor's appetite for the assumption of that risk in the furtherance of portfolio objectives. Threats and opportunities will always be with us, that is a feature of life as much as investment. The financial markets, regarded by many as the crucible in which these realities are quantified are said to reflect the sum-total of everything that is known as well as an assessment of likely outcomes the consequence of many variables acting sometimes in concert and sometime in conflict and to varying degrees of intensity.

It was Mark Twain who once observed that history does not repeat itself, but it often rhymes. There are very few still alive and operative in the financial markets today who were around during World War Two, the last time the economy (and by extension the financial markets) underwent a paroxysm such as that we have all experienced relating to the global pandemic, the policy response and its consequences.

Locking down entire populations necessitated an economic policy response, both fiscal and monetary that whilst far from ideal was surely the least bad approach. In direct consequence the money supply across Western Developed economies exploded higher giving rise to an inflationary pulse the like of which was unseen since the 1970s. If that were not sufficient, Russia's invasion of Ukraine and resultant sanctions, coupled with a confrontation between the United States and China have served to make an already severe situation even worse. In response to the inflationary firestorm engulfing developed economies, the

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world's most important central banks have been forced into the most aggressive rate hiking programme in fifty years. Financial markets, like societies more generally, are still working through the aftermath, throwing up profound divergence between and often within financial asset classes.

This divergence has given rise both to opportunities within diversified portfolios, as well as threats, manifest in an often sharply varying performance between stock markets and drilling down, between constituent sectors too. Given that benchmark indices vary compositionally, with varying weights accorded each sector across every geographic location, pronounced differences in performance were and are inevitable.

Without wishing to over-generalise, even the most worldly investor prepared to countenance the broadest horizons typically favours a substantial allocation to their home market whether it be the UK, Europe, the United States or further afield. Yet markets seldom work in isolation. Analysing why, for sake of argument, it should be that UK stocks have underperformed cannot be sufficient without reflecting on why other markets have performed as they have too.

If one single factor has defined the varying performance of developed stock markets over 2023 it has been the enthusiasm associated with the potential associated with artificial intelligence. While the pace of adoption and application of this transformative technology remains unclear, to say nothing of the regulatory and indeed political consequences, investors haven't waited to find out. So heavy a weighting does the technology sector enjoy in US benchmark equity indices (the largest five US "mega tech" stocks amount to 22% of the S&P 500 Index) that it is little wonder that country's stock market has performed as well as it has. Equally true, so beguiling are the perceived prospects that many overseas investors have been drawn into the United States and away from domestic locations. Whilst prevailing conditions feel very similar to those accompanying the "dot.com" bubble, one notable difference lies in the fact that back in the 1990s Europe was the home to many big technology companies, notably in the telecom sector. This time few listed "big tech" names originate in Europe, or the UK and are in consequence not as well represented in local equity benchmark indices.

But European stocks have outperformed their UK counterparts too. In large part this reflects the heavily cyclical composition of European equity benchmarks and that up until very recently, the regional economy has proved extremely resilient, withstanding the fallout from Russia's war in Ukraine and more particularly, concerns regarding the security of regional energy supplies. Furthermore, the banking sector is also heavily represented in European indices and whilst a frisson was felt back in March when Credit Suisse fell into the arms of Swiss rival UBS, concerns regarding contagion from the United States proved wide of the mark. Now that the lagged effect of still high inflation and higher regional interest rates are beginning to manifest, it remains to be seen how long earlier resilience can be maintained.

A period of European economic weakness reflects a more broad-based global economic slowdown. This is particularly germane for the UK stock market where the index of leading one hundred companies is heavily weighted to sectors such as mining and energy thought likely to be most adversely impacted by subdued demand. Beneath the leading index, more domestically focused medium sized and smaller company performance reflects the subdued outlook for both sales and profitability the result of the downbeat near-term outlook for the domestic economy. In the financial markets it is said that it's not what you know, but what you don't know that counts for everything and what shares are slowly repricing for is the prospect of a further, policy-induced, economic deterioration.

But even amidst this darkness those investors with long time horizons can take heart from the fact that stock market valuations across the developed world and even including the United States (if one strips out the impact of "big tech") are already discounting near-term uncertainties. What is not being discounted is the prospect of a synchronised upturn, both in economic activity and across stock markets as inflation fades, as likely it will, interest rates are lowered and the economic cycle turns again in 2024.

KEY TAKEAWAYS:

- Not putting all one's "eggs in the same basket" through investment portfolio diversification, both as it relates to geographical areas and varying asset classes is a key aspect of investment management.
- Varying assets and geographies are responding differently to the aftermath of the pandemic period and its divergent policy response, giving rise to widespread opportunities.
- The UK stock market has performed poorly against its European (and US) counterparts, in part due to the adverse impact of the pound's strength on quoted US dollar earners, limited cyclicality relative to its European counterparts and its limited exposure to technology.
- The UK stock market is a typically attractive hunting ground for investors seeking dividend income and this remains undiminished.
- A synchronised global economic upturn in 2024 should favour the UK stock market given its heavy compositional weighting to sectors very likely to be at the forefront of that revival.

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

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