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INVESTMENT STRATEGY QUARTERLY

THE INFLATION OUTLOOK

Letter from the Chief Investment Officer

Resilience is in Our DNA – And in the Markets

Sixty years ago, Marshall Nirenberg and Heinrich Matthaei began the process of cracking the genetic code. Thanks to their persistence and resilience, today's scientists developed effective mRNA-based vaccines in record time – saving millions of lives from COVID-19. With the darkest days of the pandemic behind us, investors can also appreciate the resilience of the economy and financial markets and the hopeful prospect of brighter days ahead.

As a backdrop, we'll bring a bit of scientific language to our analysis this quarter as we celebrate the amazing feats of our scientific brothers and sisters. After all, as Carl Sagan said, "Science is more than a body of knowledge. It is a way of thinking." We'll look at the *physics* of the economic momentum created by government stimulus; *dissect the anatomy* of our outlook for major asset classes; examine the *quantum leap* in the equity markets; and peer through our *telescope* at a higher S&P 500 earnings forecast.

We begin with Isaac Newton's *Law of Motion, Force = Mass x Acceleration*. Over the last year, we witnessed policymakers *experiment* with ways to force the economy out of its steepest dive since the Great Depression, applying massive fiscal and monetary stimulus at *light speed*. The Fed used the power of its record-setting $7.6 trillion (and growing) balance sheet while Congress voted $5.5 trillion of fiscal stimulus to fill the *black hole* COVID-induced lockdowns created. And the experiment's not over yet. Chair Powell has said the Fed is "not even thinking of thinking about raising interest rates" as it downplays the risk of sustained, elevated inflation. Meanwhile, Congress is in the midst of early negotiations for a multi-year 'social' and 'physical' infrastructure recovery package for later this year. With at least $2 trillion in excess disposable income and confidence growing, pent-up consumer demand should lead to a summer surge in economic activity. Given that consumer spending accounts for 70% of GDP, the demand for goods and services is the *electromagnetic force* that drives our economy.

Of course, the biggest catalyst comes directly from medical science: enhanced COVID-19 vaccine availability and the related drop in cases, hospitalizations, and deaths are paving the way to a rapid, sustainable reopening of the economy. The stronger-than-expected force of these dynamics leads our economist to lift his expected 2021 GDP growth forecast to well over 5% from 4%.

Dissecting our growth forecast into major asset classes, we expect the *supercharged* economy (the best growth since 1984) to push both inflation and Treasury yields modestly higher. We're forecasting the 10-year Treasury yield at 2% by year end, up from our original 1.5% estimate. We *hypothesize* continued Fed purchases, healthy demand from foreign investors, and the economy's interest-rate sensitivity to keep the rate *beaker* from boiling over beyond the 2% level and ruining the *experiment*. Since the return profile of fixed income will be challenged in a rising rate environment, we continue to prefer investment-grade bonds over high-yield bonds. Dollar-denominated emerging market bonds may also be attractive, boosted by our expectation of a weakening dollar.

The *astronomical* amount of fiscal and monetary stimulus has propelled the Dow, S&P 500, Nasdaq and Russell 2000 to *out of this world* record levels. Despite the *quantum leap,* we expect earnings will still be *under the microscope.* The good news is that the *kinetic energy* of the economy requires aiming the forecasting *telescope* ever higher in this strong earnings environment. As a result, we have lifted our 2021 S&P 500 earnings forecast to $190 (from $175), which correlates to a year-end target of 4,180 (up from 4,025). As long as earnings growth remains robust, we expect the bull market to remain healthy.

Investors should appreciate the *higher mathematics* of fundamental analysis. Our favored sectors include Information Technology, Communication Services, Financials, Industrials, and Consumer Discretionary because of hefty visible earnings growth and attractive valuations. Not only are these sectors leveraged to the economy in the short run, but they also have had long-term secular growth trends accelerated by the pandemic (e.g., e-commerce, streaming, advertising, broadband expansion, and fintech). Don't be distracted by the *chaos* of *hot* momentum trades, day traders, or all-or-nothing thematic calls (i.e., reopening trade vs. stay-at-home).

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To elaborate, we're cautious about some of the reopening beneficiaries (i.e., hotels, airlines, leisure facilities, etc.) as their strong rallies appear to be *defying gravity* given the lack of robust, if any, earnings over the next 12 to 18 months. Our *observation* is that selectivity will become more important at the sector, industry, and individual stock level as we begin the bull market's second year.

Our *Theory of Relativity* isn't as sophisticated as Einstein's original one. We just believe that the relatively higher growth trajectory of the US equity market makes it more attractive than other developed markets. Given its superior vaccination progress, state of reopening and aggressive policy stimulus, the US economy has generated the highest upward revisions to GDP forecasts among the world's ten largest economies so far this year. Since Asian emerging markets are relatively less expensive, a substantial rebound in economic growth (both China and India are growing over 8%) should drive those markets as well.

As global economies emerge from lockdown and economic growth accelerates, commodities have benefitted. In particular, rebounding demand drove global oil from its *state of inertia* as crude prices have returned to pre-pandemic levels. However, now that oil prices are higher, watch for producers in the US, OPEC, and Russia to increase production. With supply and demand on the same *wavelength,* the recent price momentum is likely to be tempered by rising supply. As a result, we have only modestly raised our year-end West Texas Intermediate oil target to $70 from $65.

The start of 2021 has been far more enjoyable for investors than the start of 2020, and while market volatility is likely to be more palatable in the year ahead, it does not lessen the importance of adhering to your asset allocation. Pullbacks are an *organic* occurrence in the market and there is no shortage of possible *toxic* risks. In particular, investors must watch for *boiling points* in the economy, inflation, investor exuberance, partisan politics, geopolitical tensions, and vaccine-evasive variant COVID strains. However, *chemistry* with an advisor who understands the *elements* of risk tolerance, diversification, liquidity needs, and long-term investment goals should help in designing your *formula* for success.

The last year has been a challenge for most of us. As we approach a sustainable reopening this quarter, investors can take pride in America's rediscovered resilience. The old saying "With spring comes new life and hope" may be truer than ever this year!

Lawrence V. Adam, III, CFA, CIMA®, CFP®
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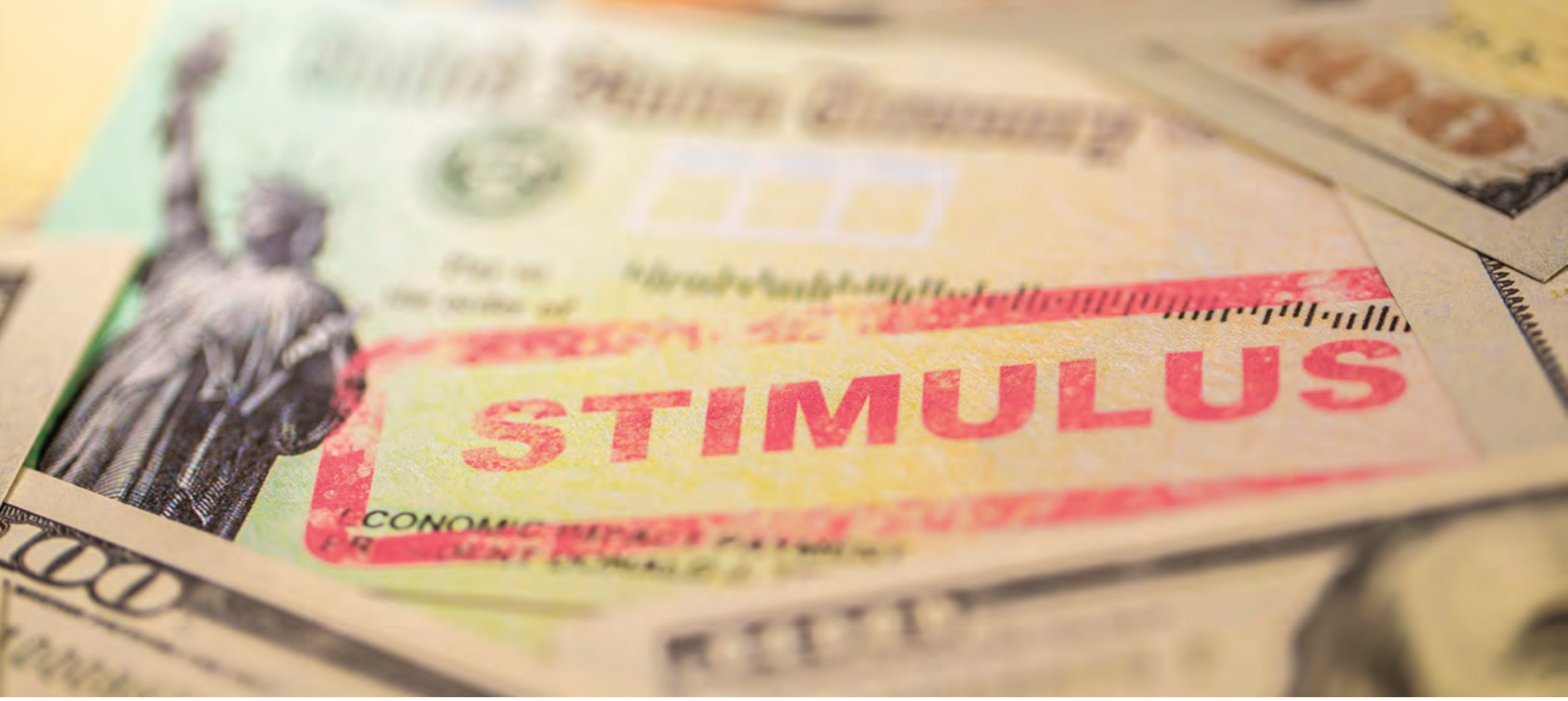


The Longer-Term Market Impact of the Biden Agenda: A Preview of a New Economy?

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

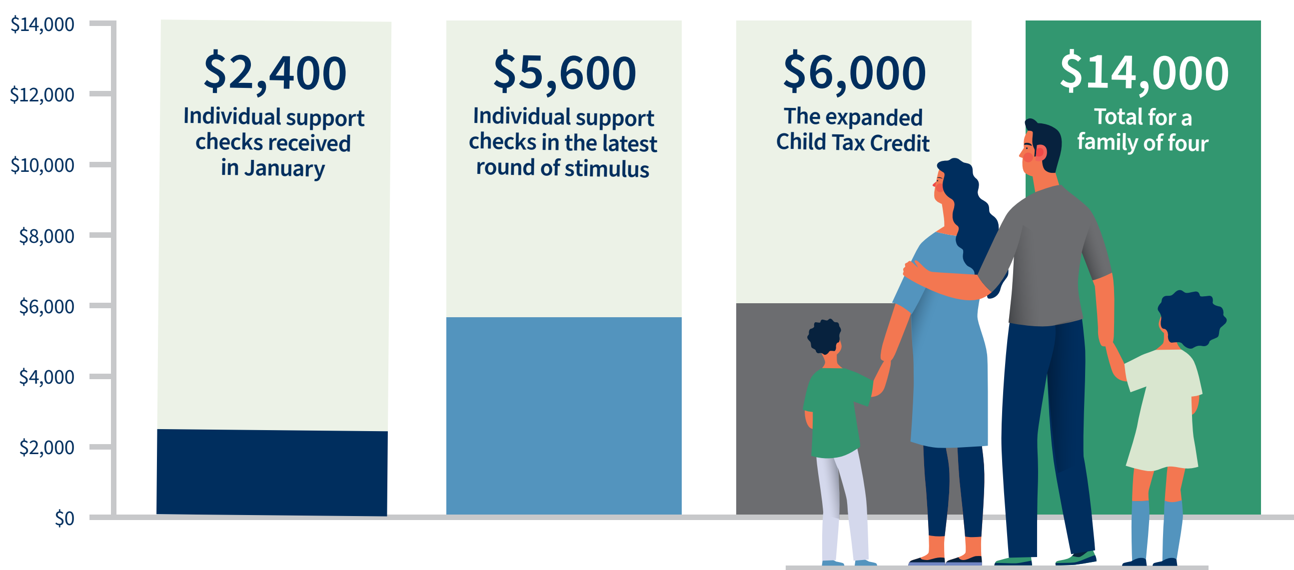
The early theme of the Biden presidency is domestic policy, working with Congressional Democratic majorities in the House and Senate to 'act fast' and 'go big' on COVID relief efforts with the first legislative priority being the $1.9 trillion fiscal relief package. The American Rescue Plan Act of 2021 (American Rescue Plan) includes $400 billion in direct response to COVID (vaccine distribution, testing, personal protective equipment (PPE), and school reopening); $1 trillion in relief to families and individuals (another round of stimulus checks, enhanced child tax credits, and unemployment benefits); and $440 billion for communities and businesses (state and local aid, small business grants and loans). This package is in addition to the approximately $3.5 trillion in fiscal support provided in 2020.

UNIVERSAL BASIC INCOME

While the next round of individual support checks (up to $1,400 per individual) has received most of the press attention of this legislation, we think it is more important to focus on the $14,000 that an average family of four, with a household income under $150,000, could receive as result of these efforts, $11,000 of which will be directly deposited into bank accounts this year. This comes from adding the individual check received in January with the $1,400 per individual check in the latest round, for a total of $8,000 per household (subject to the income limitations of the bill). The expanded child tax credit would provide $3,000 per child aged 0-6 and $3,600 per child aged 6-17 (up from a $2,000 tax credit currently). The big change with this program is monthly deposits of either $250 or $300 per child from July through December. For a family of four, this adds $6,000-$7,200 to the $8,000 received via stimulus checks. Beyond the stimulus checks and child tax credit, overall economic support is higher for house-

$14,000 Windfall

Under the American Rescue Plan, a family of four with household income under $150,000 could receive as much as $14,000 via individual stimulus checks and the child tax credit.



holds with an unemployed worker ($300 weekly), individuals with federal student loans (automatic forbearance through September), and households accessing mortgage or rental relief. These efforts are aimed at directing assistance to the lower portion of the 'K-recovery' and the expansion of the child tax credit is targeted at reducing childhood poverty in the US. From an economic, political, and market impact, these actions will be far reaching.

In the near term, we expect the market to debate the potential inflationary impact of this increased spending, with a positive impact on reflation-related equities and consumer discretionary spending.

Longer term, we believe it opens a debate on which, if any, of these programs become more permanent and whether these efforts are establishing new economic tools that government will consistently access. The size of the overall household aid, especially with monthly payments of the child tax credit and unemployment support, has similarities to calls for the establishment of a universal basic income.

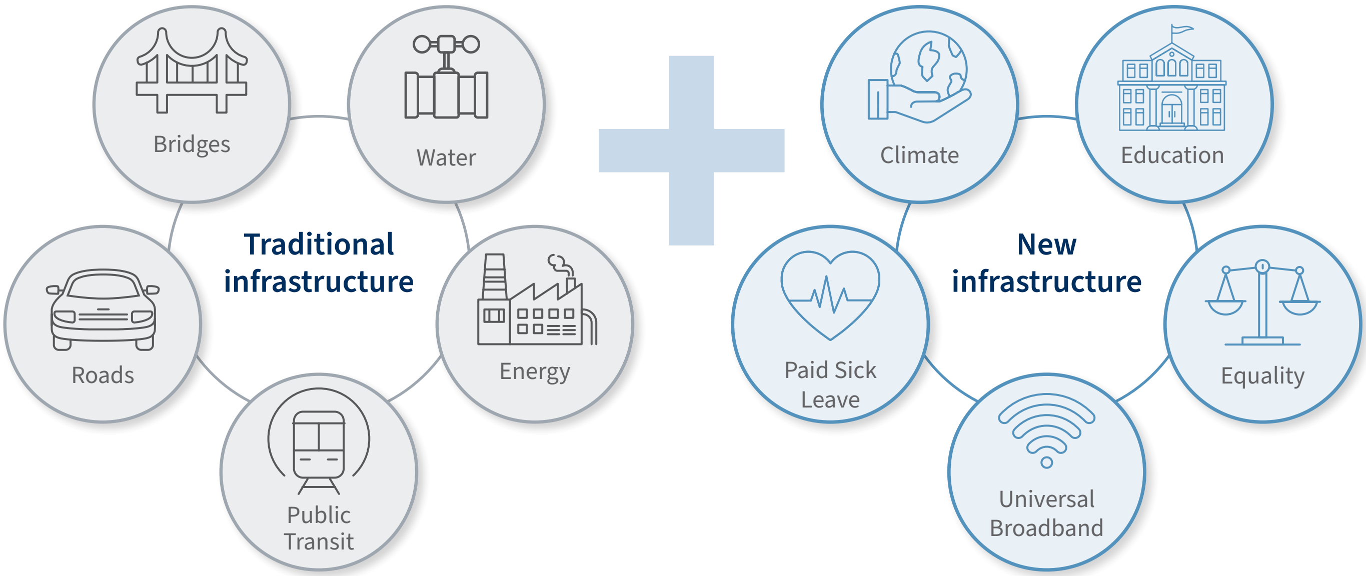
The key question is whether this is a temporary phenomenon, or if this is the beginning stage of a new normal for the US economy. Once a benefit has been created through legislation, it is very difficult to reverse. Crisis response programs, including direct payments and the more recently formulated monthly advances of the child tax credit, see some level of bipartisan support among lawmakers. This raises the likelihood that they could become more permanent fixtures of the economy. They could also be reversed depending on future Congressional majorities – adding volatility tied to election results.

THE RECOVERY PACKAGE: A BROADER DEFINITION OF INFRASTRUCTURE SPENDING

Following the $1.9 trillion American Rescue Plan, we anticipate the focus to pivot toward a recovery package, which has largely been referred to as an infrastructure package, for which we currently see appetites among Democrats in the $3 trillion range (bond market reaction/inflation metrics will be watched closely and will influence the final price tag). Importantly, while it will be referred to as an 'infrastructure bill,' it is likely to be much more than a traditional 'roads and bridges' package. Democrats view 'infrastructure' in much broader terms, including: modernization of the economy, tackling climate change, addressing racial (first time homebuyer tax credits/down payment assistance) and

A New Meaning Of Infrastructure

The modern definition of 'infrastructure' will go beyond just roads and bridges to include improvements in climate change, social justice issues and developing technologies.



economic inequalities (e.g., universal broadband), and investments in the workforce (e.g., paid sick leave). Democrats are united in advancing a recovery bill addressing infrastructure priorities, and believe that unless they deliver, they will suffer in the midterm elections. These dynamics set up a 'generational opportunity' to enact major planks of their agenda.

As typical with DC conversations about infrastructure spending, look for revenue raising measures to be floated as funding mechanisms. We expect the majority of any potential tax changes to be targeted at the corporate tax rate and at the highest income earners. Other conversations may involve a financial transactions or wealth tax, but we view these as less likely to advance. On the corporate rate, we may see a smaller initial increase followed by a multi-year phase-in to a higher rate in the 28% range, depending on the course of the economic recovery. During the debate, we are likely to see an effort to reform the current cap on the state and local tax (SALT) deduction, focused on reducing the financial incentive to move from a high-tax to low-tax state. However, this would likely go hand in hand with a return to the top individual rate of 39.6% for the highest income earners – reducing the benefit of any state/local tax deduction adjustments for higher income filers. In DC, we typically advise that major policy changes take longer than expected. Given the current uncertain economic situation, we view next year as the most likely implementation of these changes (with passage later this year), but will be watching to see if anything is implemented for 2021.

> Current political dynamics have placed domestic policy at the forefront of the Biden administration's first term agenda.

DOMESTIC POLICY AS FOREIGN POLICY

Finally, the Biden administration's focus on domestic investment is also underscored by the approach to foreign policy and trade relations. The administration's recently outlined national security strategy emphasizes that "distinctions between domestic and foreign policy have simply fallen away." Keeping with this theme, we expect the Biden administration to pursue an agenda of enhanced domestic manufacturing as a strategy closely tied to overall

Story continued on page 19

The Inflation Outlook: What, Me Worry?

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

For a variety of reasons, investors are worried about higher inflation. Some may remember the Great Inflation of the 1970s and early 1980s. Some fret over the sharp rise in commodity prices; others are concerned about the end result of aggressive monetary and fiscal policy. However, while we may see reflation – a pickup in prices that were restrained due to the pandemic – a lasting period of substantially higher inflation appears unlikely.

> Large federal budget deficits DO NOT cause higher inflation.

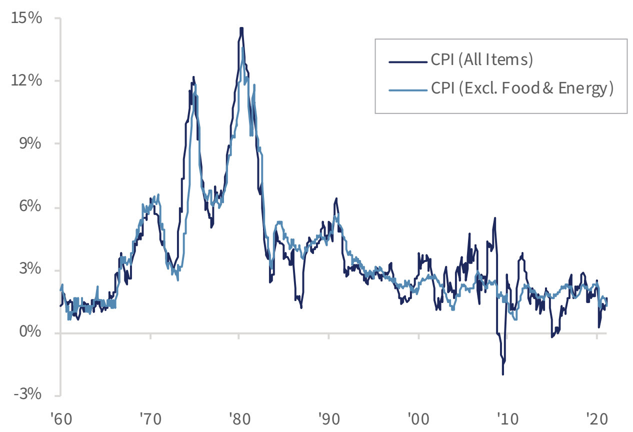
MEASURES OF INFLATION

The Consumer Price Index (CPI) measures the cost of a basket of goods and services over time. The basket represents what a typical consumer would purchase, and will change periodically as new products and services are introduced. One's own personal inflation experience will vary. If you consume a lot of healthcare and are putting your kids through college, chances are you'll face a higher inflation rate.

The Personal Consumption Expenditures Price Index (PCE Price Index), the Federal Reserve's chief inflation gauge, is similar to the CPI, but has slightly different weightings and scope. For example,

Consumer Price Index

Year-over-year % change



Source: FactSet as of 3/18/2021

> “The central bank will be more tolerant of higher inflation than it has in the past. That likely means 2.5-3.0% inflation, not much higher.”

in healthcare services, the CPI only measures out-of-pocket expenses, while the PCE Price Index covers all costs, including those paid by health insurance or government programs. Economists often exclude food and energy prices, not because they don’t matter, but because these prices are volatile and we are interested in the underlying trend. Sharp increases in commodity prices get a lot of attention. However, as former Fed Chair Ben Bernanke noted, “the direct effects of commodity price inflation on consumer inflation are empirically minuscule, both because raw material costs are a small portion of total cost and because part of any increase in the cost of materials tends to be absorbed in the margins of final goods producers and distributors.” According to Bernanke, “a reasonable rule of thumb is that a permanent ten percent increase in raw material prices will lead to less than a 0.1 percent increase in consumer prices.” Moreover, non-energy services, which are driven more by labor costs and rent, account for about 60% of the CPI and about 75% of the core CPI.

POTENTIAL SOURCES OF INFLATION

Money supply measures surged in the pandemic. However, the relationship between the monetary aggregates (M1, M2, etc.[1]), growth, and inflation broke down in the late 1980s. The velocity, or turnover, of money in the economy has slowed. The surge in liquidity during the pandemic helped relieve financial strains, supported growth, and lifted asset prices, but has not boosted inflation. Large federal budget deficits DO NOT cause higher inflation. In the 1980s, the US ran deficits on the order of 5% of gross domestic product (GDP), while inflation fell. The Japanese government has a debt-to-GDP ratio of over 235%, yet continues to battle deflation (a general decline in the price level).

The pandemic has disrupted supply chains; lengthening supplier delivery times and raising input costs, but these pressures should recede as

Inflation:

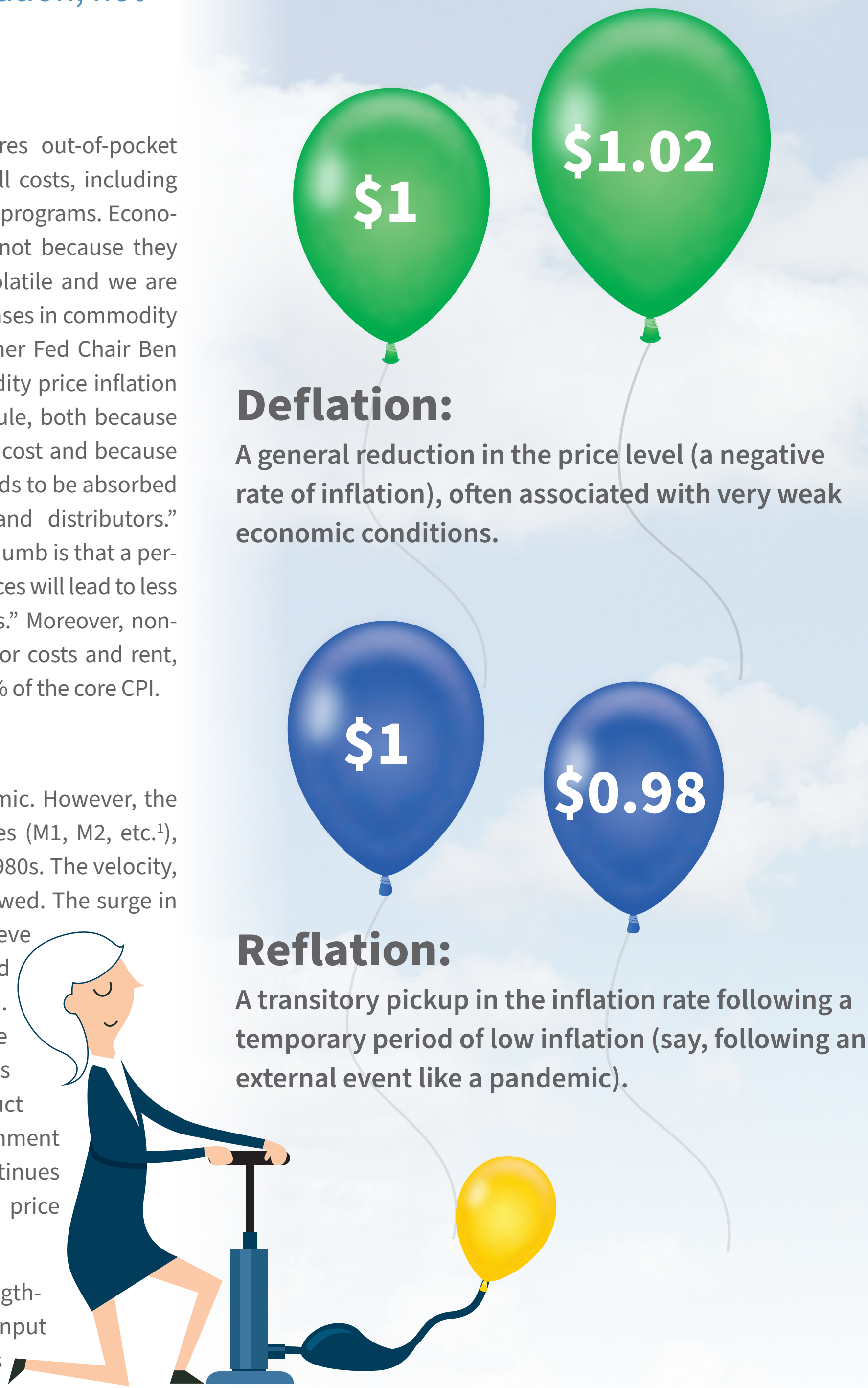
A general increase in prices over time. Inflation reduces the purchasing power of money.

Deflation:

A general reduction in the price level (a negative rate of inflation), often associated with very weak economic conditions.

Reflation:

A transitory pickup in the inflation rate following a temporary period of low inflation (say, following an external event like a pandemic).



BUSINESS ACTIVITY

[1]M1 and M2 are measurements of the United States money supply, known as the money aggregates. M1 includes money in circulation plus checkable deposits in banks. M2 includes M1 plus savings deposits (less than $100,000) and money market mutual funds.

vaccines are distributed and supply chains recover. However, while prices of industrial supplies and raw materials have increased, US firms continue to face difficulties in passing higher costs along and there is little inflation in imported finished goods. The US trade deficit widened during the pandemic, putting some downward pressure on the exchange rate of the dollar (if not offset by increased capital inflows) and upward pressure on commodity prices. However, the growth outlook for the US is stronger than other advanced economies, which should help to support the greenback.

With a limited ability to spend during the pandemic, household savings have increased. As the service side of the economy rebounds, strong demand could lead to higher prices for travel and hotels. However, there are plenty of empty hotel rooms and idle airplanes sitting on runways in the desert.

With strong demand for housing and continued supply constraints among builders, home prices have jumped in the pandemic. However, the price of a home does not factor into the CPI. The Bureau of Labor Statistics measures the service that a home provides, not its asset value — and so considers Homeowners' Equivalent Rent (which accounts for 24% of the overall CPI). Rents have risen more slowly during the pandemic.

MONITORING AND REGULATING

The Federal Reserve has a long-term inflation goal of 2% (as measured by the PCE Price Index), but the central bank made important changes to its monetary policy framework last year. Following a period of inflation below 2% (as we've seen over the last few years), the Fed will shoot for a period with inflation above 2%. There is no mathematic formula, no indication of how much inflation the Fed would abide and for how long, but the central bank will be more tolerant of higher inflation than it has in the past. That likely means 2.5-3.0% inflation, not much higher.

Economists view inflation as being driven by two factors: inflation expectations and the degree of economic slack (such as the unemployment rate or difference between GDP and its potential). Inflation expectations, as measured through surveys of professional forecasts or through market measures (such as the spread between inflation-adjusted and fixed-rate Treasurys) have remained well-anchored. Breakeven inflation rates, the spread between inflation-adjusted and fixed-rate Treasury securities, provide a rough estimate of inflation expectations. The 5-year breakeven rate has risen to about 2.4%, consistent with the Fed's revised monetary policy framework. The 10-year breakeven rate implies an inflation rate of 2% five years out, consistent with the Fed's long-term goal.

There should be ample slack in the economy well into next year. The rebound in consumer services is likely to be brisk once the pandemic is behind us, but there may be some difficulties in matching workers to jobs. Yet, one of the lessons learned from the pre-pandemic decade is that there is a lot more slack in the jobs market than would be indicated by the unemployment rate. The Congressional Budget Office provides an estimate of potential GDP, based on expectations of maximum sustainable employment and productivity growth. Vaccines will be distributed much faster than was expected earlier and with continued accommodation from the Fed and further fiscal support, real GDP is likely to approach potential GDP sooner and may even exceed it. That would imply increased inflation pressures, although estimates of potential GDP are inherently unreliable.

Inflation rose to double digits in the 1970s and early 1980s. The difference between now and then is inflation expectations. Following the OPEC oil shocks, the CPI rose sharply, reflecting higher energy prices. Unions were able to contract for higher wage gains and non-union wages followed. Inflation became embedded in the labor market and inflation expectations rose. In the private sector, union membership is now a fraction of what it was a few decades ago. Unless longer-term inflation expectations become wildly unanchored, inflation is unlikely to become a serious issue.

KEY TAKEAWAYS:

- While we may see reflation – a pickup in prices that were restrained due to the pandemic – a lasting period of substantially higher inflation appears unlikely.
- The surge in liquidity during the pandemic helped relieve financial strains, supported growth, and lifted asset prices, but has not boosted inflation.
- Unless longer-term inflation expectations become wildly unanchored, inflation is unlikely to become a serious issue.

Is the 60/40 Portfolio Dead? No *Should it be Managed?* Yes

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

Traditional stock/bond balanced accounts are a staple in investment management. This approach is primarily a volatility management tool that relies on the historically negative correlation between stocks and bonds. However, this relationship has come under strain recently. An array of central bank policy tools during this post-crisis period have altered traditional relationships between asset class performance and market participant behavior.

The diversification benefits of the 60/40 portfolio remain despite the correlation between stocks and bonds rising with the Bloomberg Barclays Intermediate Government/Credit Index modestly positive with the S&P 500 over the past three years. However, the ability for bonds to generate income is currently well below historical norms. More importantly, correlations rise with credit risk in bonds. High yield is less of a diversifier than high quality.

Time horizon and portfolio duration are key determinants of a bond allocation's performance profile. The popular financial press continues to conflate current bond yields and expected return. Most retirees can expect a 20-year plus horizon for their bond portfolios. Ownership of individual bonds, via a traditional ladder or separate account, will involve multiple periods of reinvestment. For example, a portfolio of intermediate duration will turn at least three or four times over such an investment horizon. Interest rates generally move with the economic cycle, providing ample opportunity to reposition portfolios. Even during the previous expansion from 2009 to 2019, the fixed income market experienced three mini-cycles during which the 10-year Treasury yield increased and then fell to touch 1.5%. Thus, total horizon returns will bear little resemblance to current market rates.

> Real yields are still negative, but no longer are we wrestling with the prospect of negative yields and deflation in the US.

While a tactical approach to managing around a 60/40 target may be optimal, the balanced approach at least commits to systematic rebalancing of the portfolio. Portfolio composition of the respective portfolio 'sleeves' is a critical factor to portfolio

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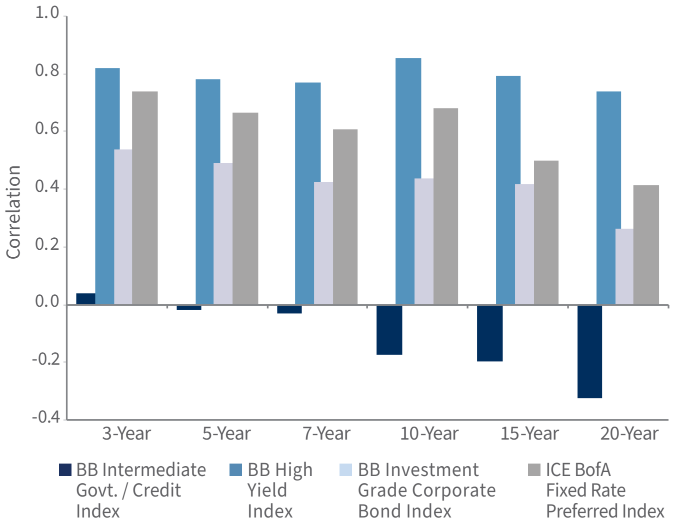
Correlation Relative to S&P 500 Index



Correlation calculated based on monthly returns for the three-, five-, and seven-year periods; quarterly returns for the 10-, 15-, and 20-year periods.

Source: Bloomberg; data as of Dec. 31, 2020.

performance and risk on top of determining appropriate asset class allocations. Within the Callan universe of balanced separate account managers, the 10-year average return ending December 31 is 8.65%, with top and bottom decile performance of 10.45% and 6.23%, respectively. The mean standard deviation is 11.34, with top and bottom deciles posting 15 and 6.54, respectively. The S&P 500 index return over this period is 13.88% with a standard deviation of 15. Much of these disparities arise from stock/bond weightings, but style within those asset classes is likely significant.

BOND MARKET INDEX COMPOSITION

In the traditional construct of a 60/40 stock/bond portfolio, the bond portion of the portfolio is the Bloomberg Barclays Aggregate Bond Index (Agg), which consists of all investment-grade fixed income securities. In 2001, the Agg consisted of 22% Treasurys, 16% government-related bonds, 23% corporate bonds, and 39% securitized mortgages.

Fast forward to today, with the massive increase in government spending and quantitative easing by the Federal Reserve (Fed), Treasury bonds now comprise 37% of the Agg with government-related bonds, corporates, and securitized mortgages representing 6%, 27%, and 30%, respectively. The increase in Treasury bonds has caused the yield-to-worst for the Agg to fall by 4.23 percentage points to 1.17% since 2001. Meanwhile, the effective duration of the Agg has increased 1.7 years over the same timeframe as the US Treasury and corporations have taken advantage of lower yields by issuing longer-dated bonds, extending the average maturity of their overall debt burden. So the increased weighting in Treasury bonds combined with Fed buying and corporate bond maturity extension have depressed yields on the Agg while increasing interest rate risk.

Beginning with the millennia, when the stock/bond correlation turned negative, investors have generally benefited from offsetting and positive returns of both assets. Central banks have anchored inflation expectations during this period, avoiding the pitfall of inflation shocks causing coincident negative returns. Since the financial crisis, central banks have struggled to achieve their inflation targets. At the same time, equity markets have become increasingly reliant on ultra-easy monetary policy, and attempts to normalize policy have hurt both stocks and bonds (as seen briefly in in the taper tantrum of 2013).

REFLATION NOW – INFLATION WATCH BEGINS

The 10-year Treasury yield hit its secular intra-day low on March 9, 2020 at 0.32% while corporate-bond spreads reached their widest level since 2008 because of the uncertainty regarding the pandemic and chaos in the capital markets. This dynamic set up extraordinarily good total returns in 2020 as spreads narrowed with Fed support and the prospects for economic recovery, but interest rates remained range bound for several months following the initial drop. Now, spreads are back to pre-COVID levels, and rates are moving higher.

We are in a market regime change. Real yields are still negative, but we are no longer wrestling with the prospect of negative yields and deflation in the US. The evidence for reflation, if not outright inflation, in the US is convincing. Commodity prices, as measured by the Commodity Research Board, are at a ten-year high. Reported inflation measures will be higher, in part due to base effects of collapsing prices last spring, but also because of changes in the materials space. Consumer spending on goods, buoyed by record government support and record money supply expansion, is one of the few economic indicators to exhibit a true 'V-shaped' recovery; however, industrial output for those same goods is lagging. With more stimulus coming, the gap between potential and real GDP continues to narrow. The 10-year break-

> "Income investors are wise to consider dividend stocks as part of balanced investing."

even inflation rate – based on Treasury Inflation Protected Securities (TIPS) – has moved higher, even though the Fed is the largest buyer of TIPS and likely suppressing true market levels.

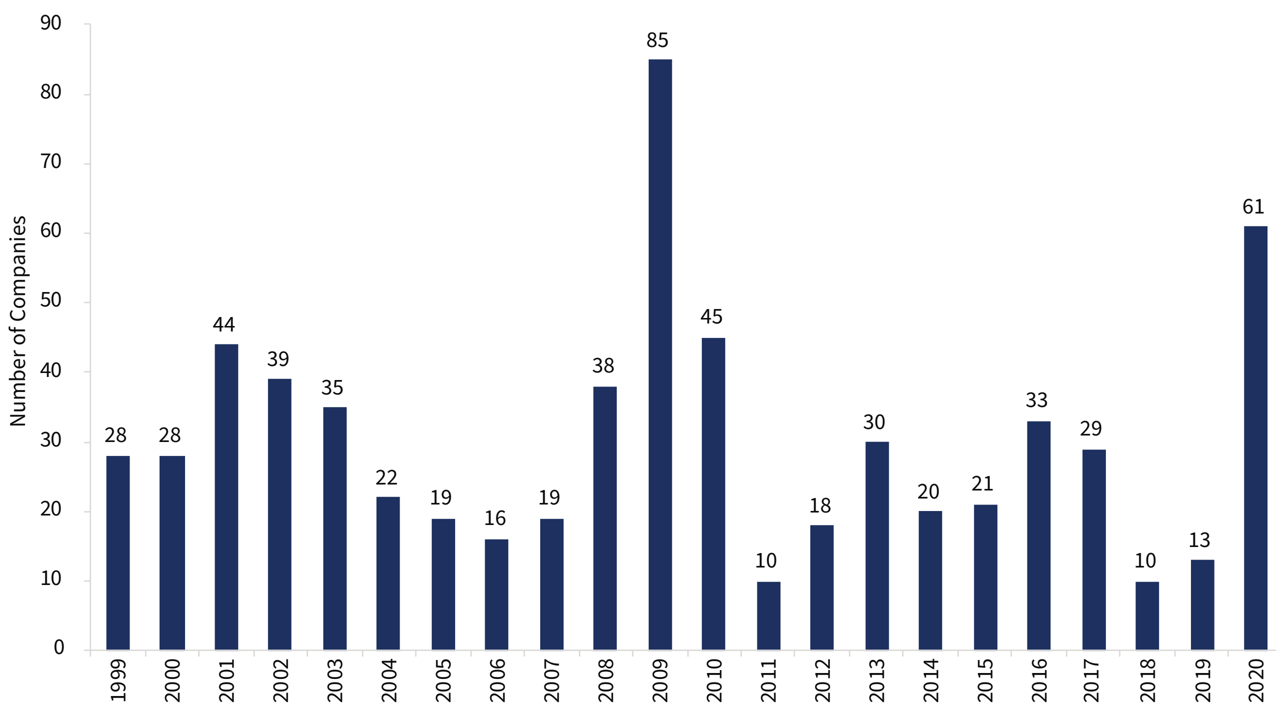
The Fed has proven tools to fight inflation should it become unanchored, but price levels will be biased higher over the coming quarters, and the Treasury market is beginning to reflect that probability. This transition is likely to cause an increase in volatility in fixed income. It is appropriate to evaluate the composition of the bond allocation and explore other areas for income generation.

CORPORATE BEHAVIOR AND DEBT – PASSIVE PRODUCTS POTENTIALLY MORE VOLATILE

Since 2000, the structure of the investment-grade market has shifted toward BBB-rated bonds. Currently, BBB-rated bonds comprise 50% of the corporate bond market, which is up from approximately 31% in 2000. Ratings migration from A-rated bonds (49% of the corporate bond market in 2000) has been a factor in this growth, but the overall size of the corporate bond market has increased 450% to $6.8 billion, with BBB-rated bonds comprising $3.4 billion of the net market value.

Corporate management teams have realized they can operate with higher leverage and lower ratings while increasing shareholder value during this time period, so they have settled into the BBB-rating category. The marginally higher interest costs do not have a material impact on earnings given today's low rates and are outweighed by the benefits to shareholders such as dividends, share buybacks, and debt-fueled M&As.

S&P Companies Decreasing or Suspending Dividends



Source: FactSet; data as of December 31, 2020

Going forward, we expect the percentage of BBB-rated bonds to remain the same or grow, but we recognize credit selection matters. For a few companies, a BBB-rating is merely a pit stop on the road to further downgrades into high yield. We recognize this dynamic and focus on companies we believe can operate safely within the BBB-rating bucket.

Flow of funds into bonds hit records in 2020, much of that into funds and passive products. These often track the aforementioned indices and may be more weighted toward bond sectors that are less attractive. On top of this, as rates rise, and the returns turn negative for a period, fund flow reversal can become a headwind. Bond allocations may be better in either individual securities or separately managed accounts.

FLEXIBILITY FOR INCOME GENERATION

Income investors are wise to consider dividend stocks as part of balanced investing given the proclivity to use the bond market for equity valuation and the often higher yield in ownership of companies. Despite the challenges of 2020, fewer companies suspended or cut their dividends than in 2008.

Dividend growth rates may be poised to expand as a recovering economy leads to less conservative balance sheet management. Income producing equities underperformed non-income producing equities by over 25 percentage points in 2020. In fact, ‘yield’ was a detractor from total return as the highest-yielding stocks performed the poorest. This interplay between yield and return is important to understand. Favoring more modest yielding equities with growth and some inflation protection, such as Materials and Financials, may weather the transition better than Consumer Staples and Utilities.

Municipal bonds are a valuable diversifier. Often these securities are less rate sensitive than Treasurys as supply/demand considerations and lack of direct central bank involvement can limit volatility. In 2020, over 30% of municipal issuance was taxable, while demand continued at record pace. We expect municipals to continue to have a more muted reaction to rising rates going forward.

Preferred securities are another source of income generation, which can offer relatively attractive yields, reduced interest rate risk through fixed-to-float structures, portfolio diversification, and potentially tax-advantaged income for US holders. Different preferred security structures, along with features of both stocks and bonds, means they’re not always well understood, but it makes them very useful depending on the market environment and helps create alpha opportunities through active management.

If the reflation theme holds, a three-pronged approach to 60/40 may be wise: equities (domestic and foreign), bonds, and some form of inflation hedge. The latter can include pro-cyclical equities (those companies that tend to be more sensitive to the economic cycle), income assets, TIPS, floating rate securities, commodities, and real estate. These should prove valuable should inflation heat up and the stock/bond correlation increase. Rate sensitivity in particular needs to be managed across all asset classes, not just bonds.

While perhaps a little broader and more tactical, the basic tenets of the 60/40 construct remain.

KEY TAKEAWAYS:

- Beginning with the millennia, when the stock/bond correlation turned negative, investors have generally benefited from offsetting and positive returns of both assets.
- Income investors are wise to consider dividend stocks as part of balanced investing given the proclivity to use the bond market for equity valuation and the often higher yield in ownership of companies.
- If the reflation theme holds, a three-pronged approach to 60/40 may be wise: equities (domestic and foreign), bonds, and some form of inflation hedge.

Global Energy Transition: What It Is, Why It Matters, and How to Invest in This Theme

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

Energy transition, also commonly referred to as decarbonization, is one of the global megatrends of our time. As it underpins the paradigm of environmental sustainability, energy transition is a megatrend not just for the next few years, but toward the middle of the century. Here is the big picture: the global economy's traditional reliance on fossil fuels (coal, petroleum, natural gas) is diminishing, as both technological/economic and political/regulatory factors drive the adoption of renewable energy sources and other low-carbon technologies. For investors, it is essential to at least conceptually recognize the impact that this megatrend will have for the entire energy value chain, along with many non-energy areas (e.g., transportation, manufacturing, and agriculture). There will be winners and losers, but not always the ones you'd expect, and with a wide range of impacts in different geographies.

For investors, it is essential to at least conceptually recognize the impact that this megatrend will have for the entire energy value chain, along with many non-energy sectors.

RENEWABLE ENERGY IS GOOD BUSINESS

Technological change is creating economic incentives for self-motivated decarbonization. Case in point: more than 280 large companies around the world, encompassing nearly every industry, have committed to source 100% of their electricity from renewable sources — and many have already achieved this target. Even more impactful, a dozen of the top-tier oil and gas producers have committed to reorient their operations toward low-carbon energy over the next 20 to 30 years. To clarify, these companies are doing it not because they are forced to by governments, but rather because they see it as good business. For example, the past decade's massive reductions in wind turbine and solar hardware costs mean that in-house wind and solar farms routinely provide lower-cost electricity for data centers as compared to buying power from the grid – and, amid frequent headlines about weather-related power outages, integrating such assets with batteries can also provide 24/7 reliability. Bus and truck fleets converting to electric or fuel cell vehicles stand to achieve savings on fuel as well as maintenance, which offsets the higher upfront cost of these vehicles. Similarly, upgrading buildings with energy-efficient windows, LED lighting, and energy management software also pays for itself over time.

> “More than 280 large companies around the world, encompassing nearly every industry, have committed to source 100% of their electricity from renewable sources.”

POLICY MILESTONES

On the policy front, there are some specific milestones that we are tracking in 2021. In December 2020, the European Union approved the European Climate Law, thereby becoming the world’s largest carbon emitter to impose a legally binding mandate for net zero CO2 emissions by 2050. As the details of the implementation roadmap are unveiled over time, the entire European economy will need to be transformed — not solely the ‘usual suspects’ (power plants and transport). The UK is no longer an EU member, but it has had equivalent legislation since 2019. In the run-up to the United Nations climate conference this November, more countries will set net zero targets — China, Japan, and South Africa have already signaled plans to do so — though the details are more important than the headlines. President Biden has proposed the same policy for the US, as well as a 100% carbon-free electricity mandate by 2035 and $2 trillion of federal spending on energy transition over four years. We are not confident that any of this can get through the narrowly divided House, and the 50/50 Senate looms as an especially tough hurdle. Thus, we will be watching how the Biden administration uses executive action (e.g., fuel economy standards, oil and gas permitting rules, and tariff policy) to incrementally boost decarbonization, as well as what happens at the state level. Much like in the US, many other jurisdictions around the world are not yet ready to enact sweeping climate reforms but still have some targeted policies, such as a coal phase-out, a carbon tax, a renewable electricity or fuel mandate, or an energy audit requirement for buildings. Contrary to conventional wisdom that only high-income countries have the ‘luxury’ to approve such policies, in reality there are plenty of emerging markets that are active in energy transition – most notably China, which in January 2021 launched what will eventually become the world’s largest carbon trading program.

SUSTAINABLE INVESTING

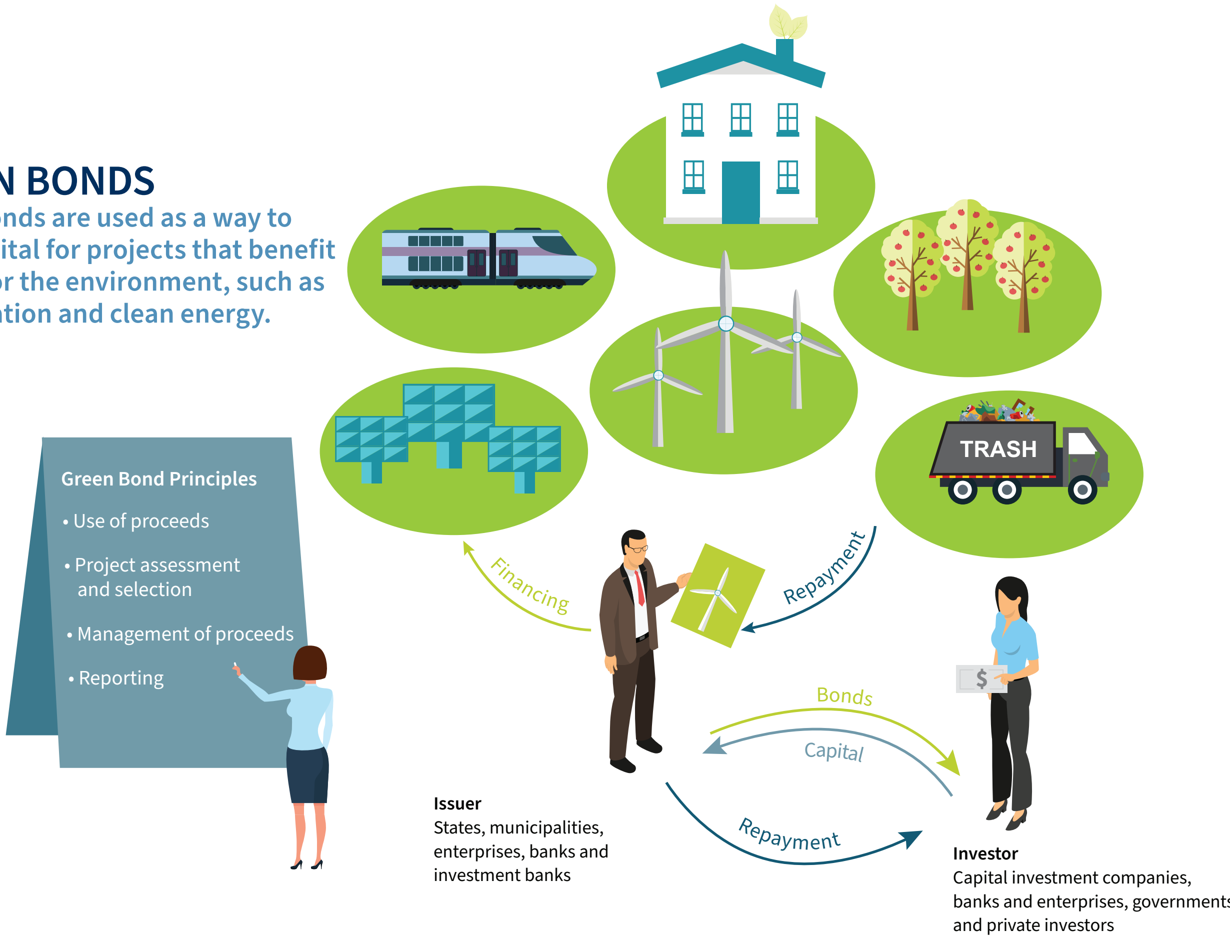
Alongside the fundamental drivers mentioned above, sustainable (ESG) investing — and, more specifically, climate investing — is raising the importance of energy transition for management teams, particularly at publicly-traded companies. Broadly speaking, there are two approaches to climate investing, and these are not mutually exclusive. First, investors can exclude those companies that are having a disproportionately negative effect on the climate. Second, they can favor those companies that are creating beneficial climate-oriented solutions. Here are the key statistics vis-à-vis ESG: as of 2020, $16.6 trillion of professionally-managed assets (equity and debt combined) in the US are covered by one or more ESG criteria, up 56% from 2018. Remarkably, this represents fully one-third of all managed assets. Within the $16.6 trillion pie, the largest single slice — climate funds — accounts for $4.2 trillion. Meanwhile, the worldwide total of funds with a fossil fuel divestment policy is approaching $20 trillion, though the vast majority of the divestments pertain solely to coal, at least for now. Divestments are more common in Europe

Milestones in Sustainable Policy

1984	1990	2006	2020	2020	2021	2030	2050
Social Investment Forum founded	Launch of the Domini Social Index, the first socially responsible investment index	Launch of the Principles for Responsible Investment (PRI)	European Climate Law approved	John Kerry appointed special presidential envoy for climate	China launched what will become the world's largest carbon trading program	UN sustainable development goals target date	EU target date for net zero CO2 emissions

GREEN BONDS

Green bonds are used as a way to raise capital for projects that benefit climate or the environment, such as reforestation and clean energy.



than elsewhere, and more common among universities and foundations than traditional asset management firms. Looking at debt specifically, green bonds are a popular way to raise capital for projects with a positive climate impact, including below-the-radar projects such as reforestation, public transit, or making the electric grid more resilient.

ENERGY TRANSITION HAS UNLIMITED SCOPE

Investing in energy transition does not need to be limited to high-beta, high-multiple stocks of solar, electric vehicle, or hydrogen companies (which is what tends to come to mind first). Certainly there are plenty of options in the clean tech sector – the aggregate market cap is approximately $1.5 trillion, the highest ever – but businesses in many other sectors are also playing a role. For example, some banks and insurers are more active than others in boosting lending to renewable energy initiatives and/or cutting back on lending to fossil fuels. Alongside the well-known electric vehicle (EV) pure-plays, just about every major automaker has EV models available, and some have committed to becoming exclusively electric over the long run. Food, beverage, and other consumer goods companies are taking steps to reduce single-use plastics, which sometimes involves partnering with startups developing bio-based chemicals. REITs and homebuilders are deploying energy-efficient technologies across their asset base. The bottom line is that investors ought to be creative, rather than only looking at the well-known high-flyers.

KEY TAKEAWAYS:

- Energy transition is a megatrend not just for the next few years but toward the middle of the century.
- A dozen of the top-tier oil and gas producers have committed to reorient their operations toward low-carbon energy over the next 20 to 30 years. They are doing it because they view it as good business.
- Sustainable (ESG) investing – and, more specifically, climate investing – is raising the importance of energy transition for management teams, particularly at publicly-traded companies.

Sustainable (ESG) Investing considers qualitative environmental, social and corporate governance criteria, which may be subjective in nature. There are additional risks involved, including limited diversification and the potential for increased volatility. There is no guarantee that these products or strategies will produce returns similar to traditional investments. Because criteria exclude certain securities/products for non-financial reasons, investors may forego some market opportunities available to those who do not use these criteria.

Economic Snapshot

The faster arrival of vaccines and the further fiscal support have significantly boosted the outlook for GDP growth in 2021. Growth is expected to be led by a rebound in consumer services, which had been held down through the pandemic. Chair Powell has indicated that the Federal Reserve (Fed) will remain accommodative until the central bank is a lot closer to its goals. A moderate, transitory increase in inflation will be tolerated, but the Fed remains firmly committed to a long-term goal of 2% (on average). Risks include a possible reluctance to be vaccinated and difficulties matching unemployed workers to available jobs.

DR. SCOTT BROWN
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	Led by a recovery in consumer services, GDP growth is expected to be strong. Fiscal support will add to that strength and ensure the recovery remains robust into 2022.
FAVORABLE	EMPLOYMENT	Nonfarm payrolls are still down by about 9.5 million from where they were before the pandemic. Job growth should be strong, but there may be some difficulties in matching unemployed workers to available jobs.
FAVORABLE	CONSUMER SPENDING	As vaccines become more widely distributed, we should see a strong recovery in consumer services, perhaps with some moderation in spending on consumer durables (which had been strong during the pandemic).
FAVORABLE	BUSINESS INVESTMENT	Business spending on equipment appears to have picked up, reflecting optimism about the global economic recovery. Investment in business structures is likely to be mixed.
FAVORABLE	MANUFACTURING	With economic strength showing up sooner than expected, manufacturers have generally struggled with supply chains. That should clear up over time.
FAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	Mortgage rates are off their lows, but demand for housing is expected to remain strong as work-from-home continues beyond the pandemic. Supply constraints will likely add to home prices, reducing affordability.
FAVORABLE	MONETARY POLICY	Fed officials expect short-term interest rates to remain low through 2023. The monthly pace of asset purchases is likely to be reduced at some point, but probably not anytime soon.
FAVORABLE	FISCAL POLICY	Fiscal support is now much larger than many thought possible, and an infrastructure package is possible later this year. Lawmakers should work to put the budget on a long-term sustainable track, but not now.
FAVORABLE	REST OF THE WORLD	A mixed bag, but a worse outlook than three months ago. Most developed economies have successfully tamped down the number of new infections, while many emerging economies have done a lot worse.
NEUTRAL	INFLATION	Year-over-year inflation should pick up in the near term, reflecting a rebound from low figures a year ago. Sharp increases in commodity prices do not translate into higher inflation at the consumer level, but CPI inflation is expected to rise moderately (and temporarily), as the economy improves.
NEUTRAL	LONG-TERM INTEREST RATES	Bond yields normally rise in an economic recovery. However, Fed asset purchases should prevent long-term interest rates from rising too much.
NEUTRAL	THE DOLLAR	The trade deficit is likely to widen further, putting some downward pressure on the dollar (if not offset by increased capital inflows). However, a stronger US economy ought to be supportive over the long term.

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	INFORMATION TECHNOLOGY	26.4%	We remain Overweight in the Technology sector. The deteriorating technical picture and obvious rotation in the market does cause some angst. However, with fundamental trends healthy (note the revision trends for 2021 and 2022) we are going to stay Overweight for now. As the year progresses, fundamentals should overcome 'factor' investing.
OVERWEIGHT	CONSUMER DISCRETIONARY	12.4%	We remain Overweight in the Consumer Discretionary sector with a bias to favor the equal-weight index. Record levels of consumer savings, additional government transfer payments coming, and a return to semi-normal later this year are compelling tailwinds for investors in Consumer Discretionary stocks.
OVERWEIGHT	FINANCIALS	11.6%	We are moving to Overweight for the Financials based on a time frame beyond 3 months. The outlook for the sector is much brighter given higher interest rates and expectations for rapid economic growth this year. Earnings estimates are being revised higher due to the more favorable backdrop. The sector's tight correlation (91% over the past 12 months) highlights the importance of interest rate moves for the sector, at least for the near term. With interest rates experiencing a rapid increase (recent 3-standard deviation move in the 2/10 year is the only one recorded over the past 30 years), they may pull back at any time and take the Financials with them. We would not wait for such an occurrence, given our belief that the yield curve remains steep and interest rates will be higher over the next 12 months. The attractive relative valuation is an additional reason to favor the sector.
OVERWEIGHT	COMMUNICATION SERVICES	11.2%	We continue to favor the Communication Services sector. The sector will not see the heady earnings growth of the deep cyclical sectors in 2021. However, consensus forecasts reflect respectable mid-teens growth for the year. Adding attractive valuation and positive technical momentum to the expected earnings growth reaffirms our Overweight stance.
OVERWEIGHT	INDUSTRIALS	8.8%	We expect Industrials to benefit as investors seek ways to play the economy accelerating in the months ahead. The sector will get an additional boost as manufacturing benefits from companies scrambling to replenish under-stocked inventories.
EQUAL WEIGHT	HEALTH CARE	13%	We are moving to Equal Weight in the Health Care sector. Since we have a bullish bias toward equities this year, especially for the cyclical sectors, as the world speeds to reopening, we are lightening exposure to this defensive sector. Political pricing pressure (Biden's infrastructure plan involves lower Rx prices) on the pharmaceutical and biotech subsectors will likely continue to weigh on the sector, as the two make up over 40% of the sector. Technical weakness, especially on a relative basis, caps our rationale for backing off for now. For longer-term/patient investors, we remain very constructive given positive fundamentals and attractive valuation. Additionally, there are numerous opportunities as many subsectors are less impacted by the political overhang.
EQUAL WEIGHT	ENERGY	2.8%	We maintain our Equal Weight recommendation in Energy. Crude prices and Energy stocks are pulling back from a recent March 11 price peak. For those underexposed in the sector, we would use the pullback as an opportunity to add to positions. OPEC boosted crude oil prices in early March as they decided to maintain current production cuts. Although they could reverse course in subsequent meetings, it is clear they favor higher crude oil prices. The message from OPEC, the restraint on production in the US, and the move to reopen the global economy suggest crude prices should maintain a solid bid in the months ahead. The Energy space is a high beta area investors can accumulate during pullback periods, such as now.
EQUAL WEIGHT	MATERIALS	2.7%	We remain Equal Weight in the Materials sector. The need to replenish inventories will create demand for Materials and benefit companies across the sector. The rapid rise in earnings revisions reflects the positive backdrop. We will maintain an Equal Weight given a greater preference for other deep cyclical areas.
UNDERWEIGHT	CONSUMER STAPLES	6.1%	We maintain our Underweight recommendation to Consumer Staples, as we find the more cyclically-exposed sectors better opportunities for the economic recovery ahead. Modest earnings growth for the Consumer Staples sector, relative to the explosive growth we will likely see from other sectors, further influences our decision to maintain limited exposure to this defensive sector.
UNDERWEIGHT	UTILITIES	2.6%	We remain Underweight Utilities. With the world moving toward reopening, we feel investors will continue to accumulate more cyclical areas than the defensive Utilities sector.
UNDERWEIGHT	REAL ESTATE	2.4%	We remain Underweight the Real Estate sector. Although we see select opportunities for income investors at the stock level, we will remain Underweight the potentially interest rate-sensitive sector.

economic and national security, which elevates the issue in a bipartisan manner for this year. We have already seen the first steps taken in this direction, with an early push by the Biden administration to enhance 'Buy America' procurement provisions in federal spending to invest in domestic producers and suppliers. We expect this to be a longer-term theme of economic policy, as it is closely tied in the eyes of policymakers to the ability of the US to remain competitive with China. Domestic manufacturing capability in next-generation technologies such as 5G, artificial intelligence, quantum computing, and semiconductors will also be a key area of focus with federal investment and incentives directed toward technology supply chain reshoring. We expect this shift in economic policy to be a primary driver in Biden's foreign policy, guiding relations with traditional allies, competitors, and adversaries.

To conclude, current political dynamics have placed domestic policy at the forefront of the Biden administration's first term agenda. Although the next election is just around the corner in DC terms, the Democratic sweep solidified in January carries with it the potential for the Biden administration to make significant economic reforms – from consumer support programs to domestic manufacturing incentives – a more permanent fixture of the US economy.

KEY TAKEAWAYS:

- The early theme of the Biden presidency is domestic policy, working with Congressional Democratic majorities in the House and Senate to 'act fast' and 'go big' on COVID relief efforts.
- The size of the overall household aid, especially with monthly payments of the child tax credit and unemployment support, has similarities to calls for the establishment of a universal basic income.
- The 'recovery' package takes a broader, non-traditional view of infrastructure, including: modernization of the economy, tackling climate change, addressing racial and economic inequalities, and investments in the workforce.
- Current political dynamics have placed domestic policy at the forefront of the Biden administration's first term agenda.

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