

# INVESTMENT STRATEGY QUARTERLY

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# Letter from the Chief Investment Officer

## Investing Is Not a Trivial Pursuit®

**Americans, bored in their COVID-induced ‘bubbles,’ turned to board games for fun last year, boosting sales 300%. They rolled the dice, drew the cards, and buffed the skills of cooperation, problem solving, emotional intelligence, and reflective logic — the same competencies critical to successful investment strategies. So, we couldn’t help looking back nostalgically to our favorite games — and probably yours — as we look forward to crafting a sustainable investment game plan.**

Like players in Clue®, ‘The Classic Mystery Game,’ we have to be good detectives, hunting for clues to either affirm or alter our views. These unprecedented times are a whole new game, often demanding a fresh financial toolkit to solve the mysteries of the market. In other words, it’s no Trivial Pursuit®.

Remember how good you felt, passing ‘Go’ in Monopoly® and collecting \$200? Now imagine the US economy as consumers pass ‘Go’ with a collective \$2 trillion in excess spending capacity as a result of Congress’ generous, stimulus-driven ‘Community Chest.’ That chest continues to grow with the Child Tax Credit beginning in July and prospects for additional government infrastructure packages. While taxes are likely to move higher for corporations and the wealthy, the ‘Income Tax’ card will be less onerous than originally outlined. With the US debt ceiling likely raised by the end of July or soon thereafter, there is little ‘Chance’ of government default or bankruptcy.

Of course, the real game-changer for the economy wasn’t the ‘Get Out of Jail Free’ card; it was the ‘Get Out of the House for Free’ vaccine process that has inoculated more than 60% (and growing) of US adults. Now that consumers can join friends for dinner, go to sporting events and concerts, and travel on planes, the US has regained all of its economic activity lost during the recession. The hot real estate market proves that people are ‘buying properties’ in classic Monopoly® fashion and higher home prices are a key driver of the positive wealth effect for consumers. Once more, economic growth should go racing around the board on the back of robust consumer spending, rebuilding inventory levels, recovering foreign economies, and rising US employment (expect an average of 500,000 new jobs a month over the next six months). As a result, 2021 GDP growth will likely meet, if not exceed, our expectation of 6.2% and remain strong into 2022.

In the 1960s, Milton Bradley introduced battery-powered Operation®, which tested kids’ ability to remove ‘butterflies in the stomach’ and other ailments without setting off a buzzer. As the economy heals, the ‘money doctors’ at the Federal Reserve (Fed) will be delicately removing some of the ultra-accommodative monetary policy that nursed the economy back to full speed. The trick: remove pieces from the accommodative policy without being zapped by surging inflation or short-circuiting the economy. The Fed will need to keep a steady hand and be patient. If inflation proves transitory and peaks during the third quarter as we expect, the Fed will be able to taper its bond purchases by late this year/early next year and not raise rates until 2023.

Fixed income investors will need to remain flexible — like the players in the famous party game Twister®. Global investors will be stretching for yields in an environment of near record-low (if not negative) yields. Positive yields in the US seem like a winner, continuing to attract foreign investors and keeping yields lower than valuations may suggest. However, the healthy US economic environment and the uptick in inflation should push yields higher. These entangling forces are keeping yields knotted in a tight range, but we ultimately expect the 10-year Treasury to move modestly higher and finish the year at about 2.0%. If yields move decisively above 2%, don’t be surprised if the Fed adds its own ‘Twist’— purchasing bonds on the long end of the curve to keep interest rates lower. While the strength and breadth of the economy remain solid, valuations continue to favor the highest quality bonds from a risk/return perspective.

In equities, it’s easy to Connect Four® reasons why this young bull market will continue for the foreseeable future: 1) a still-improving macroeconomic backdrop; 2) attractive valuations, especially versus bonds; 3) increased shareholder activities in the form of growing dividends and buybacks; and 4) strong earnings growth

expectations. With earnings growth expected to surge more than 60% during the second quarter and maintain a vigorous trend into 2022, equities should grind higher, albeit at a slower pace than over the last year. We revised our 2021 year-end target for the S&P 500 to 4,400 and expect it to rise to 4,600 by year-end 2022. A modest corporate tax increase to 25% (from the current 21%) shouldn't deter a string of positive quarterly earnings. While our bias remains more US-centric with a focus on US large-cap and small-cap stocks, it's possible an acceleration in reopenings in other parts of the world (like Europe) could lead to potential short-term trading opportunities. Our growth versus value positioning is more of a 'draw' as our preference for big-cap Technology and Consumer Discretionary is offset by our preference for Financials, Energy, and Industrials.

So far this year it's been Candy Land® for commodity investors, with gradual, sustainable reopenings across the globe leaving sellers vying for key inputs to satisfy pent-up demand. Investors found 'King Kandy' as lumber and industrial metals raced to or near record highs due to bottlenecks. These price increases should subside as supply constraints dissipate. In terms of global oil demand, the recovery in North America, China, and Europe has been substantially realized, but still-intact COVID restrictions leave much of South Asia, with its 1.4 billion people, on the dreaded 'licorice space' – the sticky spot that slows down the game. We anticipate it won't be all 'lollipops and rainbows' for global oil demand until

mid-2022. Demand from South Asia is critical to reaching the pre-pandemic peak of 100 million barrels per day. OPEC+ (includes Russia) continues to exercise discipline in adjusting supply levels, but investors should consider the potential for US sanctions to be lifted on Iranian oil. Therefore, we are only slightly raising our year-end target for West Texas Intermediate to \$75 from \$70 per barrel. Further supporting commodities is our expectation that the US dollar will weaken slightly by year end versus major currencies like the euro (year-end target: 1.25 EURO/\$).

Despite our optimistic message, there is no lack of potential Risk®: COVID variants, geopolitical tensions, and politics. However, taking on undue risk to your portfolio is Taboo®. Just like these classic games, the rules for investing remain timeless — adhere to your asset allocation strategy, periodically review your goals and objectives, don't let emotion dictate your investment decisions, and, of course, work with your advisor. A successful investing team can make the real Game of Life® even more enjoyable! Best wishes for a wonderful summer! ■



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

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# The Evolution of Money

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

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Money is the lifeblood of the economy, a key factor in the historical development of society. Try to imagine life without it. However, money has changed a lot over time and technology will continue to drive further changes, offering benefits as well as potential risks.

Economists note three functions of money: it is a medium of exchange, a store of value, and a unit of account. Money is liquid so it can easily be used to purchase goods and services. Inflation reduces its purchasing power over time, but otherwise, money can be saved and spent later. Money serves as a yardstick to measure accounts, costs, and prices.

## A BRIEF HISTORY

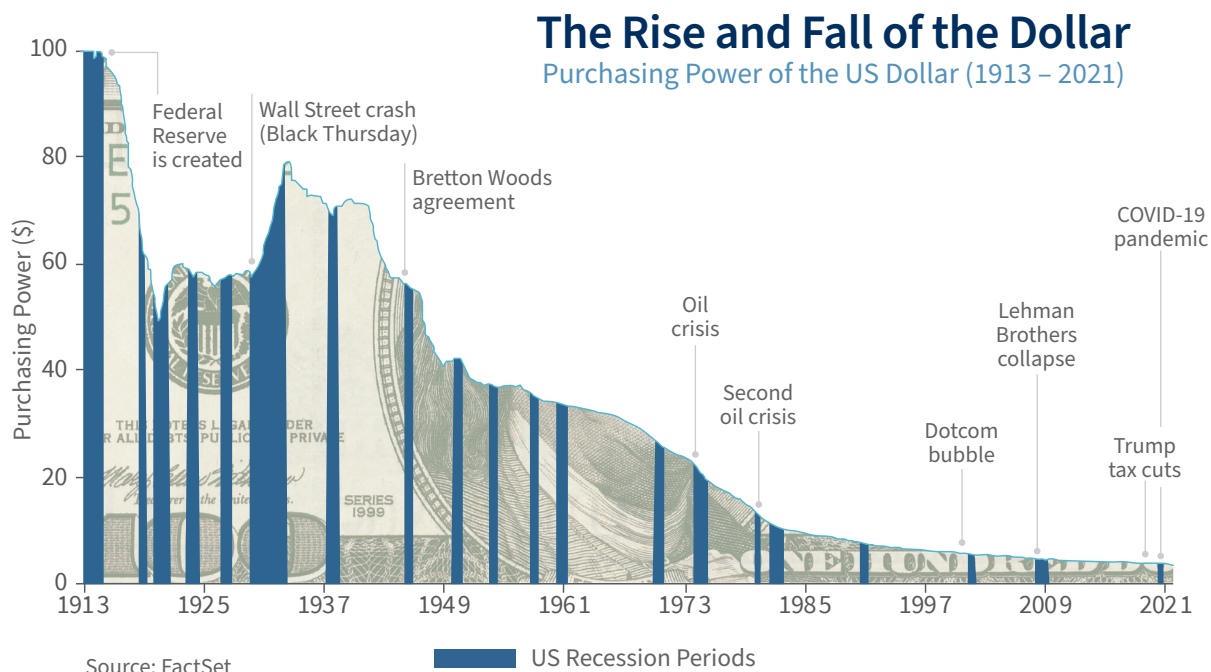
Prior to the development of money, people had to barter, exchanging one type of good for another. An easier way was needed to keep track of who owed what to whom and so systems of ledgers were developed. In some places these IOUs were in tokens, such as shells, beads, or whale teeth, which could be exchanged, serving as an early type of money (as well as credit).

These early forms suffered from a lack of central control or enforcement.

As civilization developed, metals such as bronze, copper, or tin, would be exchanged, with the idea that they had an end use (they could be made into cooking utensils or weapons, for example). Authorities began to issue coins, and the value would be based on the metal used. This helped to improve commerce, but the value depended on the scarcity of the type of metal used. Gold and silver coins became more common.

When Marco Polo returned from the East, he reported that the Chinese were using paper money. At the time, this sounded like a crazy idea, but eventually it caught on. Initially, the paper money was backed by a physical commodity such as gold or silver, the value of which changes depending on supply and demand. When gold and silver began arriving from the New World, inflation in Europe increased.

The US and other countries left the gold standard (the backing of paper money by a reserve of gold) in 1973, and we now have what's called 'fiat money.' That is, there is no inherent value in the dollar; its worth is determined by a shared concept of what it can buy. The dollar is 'legal tender,' meaning that courts of law recognize it as a satisfactory payment of monetary debt.



### FRACTIONAL BANKING AND THE CREATION OF MONEY

These days, the concept of money includes much more than hard currency. In fact, paper currency and coins account for a tiny fraction of transactions.

There are a number of money supply measures, each reflecting degrees of liquidity. The monetary base includes currency in circulation and reserves of banks and other depository institutions held at the Federal Reserve. M1 includes currency held by the public and checking accounts. M2 equals M1 plus savings deposits, small-denomination time deposits (less than \$100,000), and retail money market fund shares.

The Federal Reserve (Fed) creates money through open market operations, buying Treasury securities from commercial banks using money it creates out of thin air. The Fed receives the securities from the commercial bank and issues them bank reserves. These reserves are then multiplied through the fractional reserve banking system\*.

Banks are required to hold a certain percentage of deposits in reserve. The rest can be lent out, adding to the money supply. By making loans (in excess of required reserves), the money supply is expanded. The Federal Open Market Committee, which includes the members of the Fed's Board of Governors and five of the twelve Fed district banks, raises or lowers short-term interest rates to adjust bank reserves.

The relationships between the monetary aggregates (M1, M2, etc.) and growth and inflation broke down by the early 1990s. The Fed still keeps track of the money supply measures, but doesn't place much weight on them in setting monetary policy.

### STORE OF VALUE AND INFLATION

The Fed has two legislated goals (the dual mandate), price stability and maximum sustainable employment. Most other central banks have just one focus, price stability. The Fed interprets price stability as 2% inflation in the Personal Consumption Expenditures (PCE) Price Deflator.

In the past, the dual mandate was seen as one primary goal in practice. That is, if the Fed worked to keep inflation low and steady, the job market would be stronger on average. If the Fed let inflation get out of hand, it would have to raise interest rates more to get inflation back down, weakening the economy and boosting unemployment; thus, the Fed would act preemptively to head off inflation.

The Fed's thinking has evolved over time, and after a lengthy review, it announced a formal change in its monetary policy framework in August 2020. The Fed now has an average inflation targeting system. The long-term inflation goal remains at 2%, but following a period of inflation below 2%, the Fed will pursue a period of inflation above 2%.

\*Fractional reserve banking is a system in which only a fraction of bank deposits are backed by actual cash on hand and available for withdrawal.

The Fed also made its employment goal broader and more inclusive. It will look at a wide range of labor market indicators in setting monetary policy. During its review, the Fed discovered that low unemployment is especially beneficial to lower-income communities.

The new policy framework is now being tested at a time of great uncertainty. Inflation is higher on a year-over-year basis, but that partly reflects a rebound from the low inflation of a year ago (these are called ‘base effects’). Production bottlenecks and materials shortages occur in economic recovery, but these difficulties are resolved over time. Pressures are more intense than usual now because this is a very rapid recovery.

Inflation expectations are a key driver of actual inflation. If workers anticipate higher inflation, they are more likely to ask for wage increases and businesses are more likely to raise prices. Inflation expectations have moved higher in the last few months, but have begun to moderate. The key is whether higher inflation expectations are sustained – and we won’t know for sure until after the fact.

While Fed officials believe that inflation pressures will prove to be transitory, they are confident that they have the tools to bring inflation down if we get a sustained increase in the underlying inflation trend.

## CRYPTOCURRENCIES AND DIGITAL CURRENCIES

Cryptocurrencies, such as Bitcoin, Ethereum, and Dogecoin, are digital assets, using distributed ledger technologies, such as blockchain, to secure transaction records and verify transfers. They are an elegant solution to no particular problem with conventional money.

The use of cryptocurrencies as a medium of exchange is limited. They can be used to buy a small number of goods and services and transaction fees tend to be high. They may store value, but as we’ve seen, that value can change dramatically from day to day. To date, cryptocurrencies have not served as a convenient way to make payments.

Critics have likened cryptocurrencies to a pyramid scheme and point to a number of negatives. They are used widely in money laundering, the illegal drug trade, and other criminal activities (but then again, so is paper currency). A lot of energy is used in mining new cryptocurrency, adding to concerns about climate change.

Digital currencies, including cryptocurrencies, are money in electronic form. Central Bank Digital Currencies (CBDC) are (or will be) issued by a central bank. China has a digital Renminbi, but most other central banks are still studying CBDCs. As part of the money supply, CBDCs will still be a fiat currency, but will offer security in transactions and transfers.

Some cryptocurrencies, called ‘stablecoins,’ are tied to a hard currency (such as the dollar). Stablecoins improve payment efficiency, speed up settlement flows, and reduce user costs, but they don’t offer the same protections as conventional payment systems, like your bank account.

The Fed has been studying the risks and benefits of CBDCs for several years now and will issue a discussion paper summarizing its findings this summer. Fed chair Powell indicated that “Our forthcoming paper on the evolution of digital payments is intended — along with our other work as a supervisor, regulator, and payment system operator — to advance the objective of ensuring that the payments system and the economy work for all Americans.”

## IN CONCLUSION

Cryptocurrencies are not going away anytime soon, but they won’t replace the dollar. Large fluctuations in value and high transaction fees make them inappropriate for use in regular commerce. CBDCs, tied to conventional securities like the dollar, are coming, which will have many of the attractive features of these new types of money, but will also provide better security and steadier value.

Electronic payments have been with us for a long time. In its early days, the Federal Reserve ensured bank transfers made by telegraph. Credit cards have advanced significantly and we can now transfer funds using our cellphones. In that sense, the future is already here. ■

### KEY TAKEAWAYS:

- These days, the concept of money includes much more than hard currency. In fact, paper currency and coins account for a tiny fraction of transactions.
- The Fed now has an average inflation targeting system. The long-term inflation goal remains at 2%, but following a period of inflation below 2%, the Fed will pursue a period of inflation above 2%.
- While Federal Reserve officials believe that inflation pressures will prove to be transitory, they are confident that they have the tools to bring inflation down if we get a sustained increase in the underlying inflation trend.
- Cryptocurrencies are not going away anytime soon, but they won’t replace the dollar.





# The Road Ahead for Biden's Infrastructure Agenda: Impact on Spending, Deficits, and Taxes

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

After more than a year of pandemic-related market uncertainty, attention is turning to the recovery stage of US policymaking and the more than \$4 trillion in infrastructure and social program spending outlined by the Biden administration earlier this year. While negotiations are highly in flux and divergent outcomes cannot be fully ruled out, current indications are that an infrastructure package in the \$2 trillion to \$3 trillion range, with about \$1 trillion in deficit spending, is likely by the end of this year or early next year.

Broadly, we expect a final package to cover three main pillars: traditional infrastructure (such as roads, bridges, and highways); investment in US domestic manufacturing through clean energy and next-generation technology supply chains; and investment into social infrastructure via an extension of the recently-enacted Child Tax Credit expansion and increased funding for education. Along these lines, we expect Congress to take select portions of the American Jobs Plan (AJP) and American Families Plan (AFP) and pair them with associated tax adjustments to raise revenue, tilted more toward corporate tax changes.

While negotiations are highly in flux and divergent outcomes cannot be fully ruled out, current indications are that an infrastructure package in the \$2 trillion to \$3 trillion range, with about \$1 trillion in deficit spending, is likely by the end of this year or early next year.

The question remains, where do we go from here? The path forward will be guided by political decisions, particularly on the size of the package (large, single bill, or separate attempts) and whether it advances with bipartisan support or by a Democratic-only reconciliation push requiring only a simple majority in the Senate. These factors will influence the final provisions of the infrastructure package, and should be monitored as legislation is crafted into the fall.

## WHAT'S PROPOSED VS. WHAT'S POSSIBLE

From a high level perspective, Biden's American Jobs Plan (AJP) proposes around \$2.3 trillion over ten years, with the core of the package targeting traditional transportation infrastructure and domestic manufacturing capability. The plan also envisions around

## Estimated Spending on the Proposed American Jobs Plan

Infrastructure at Home \$726 billion			Transportation \$621 billion		Businesses \$580 billion		Caretaking \$400 billion
Affordable and sustainable housing \$213B		Education \$137B	Electric vehicles \$174B	Rail \$80B	Manufacturing and small business \$300B		Care for elderly and disabled people \$400B
		Other \$28B					
Water \$111B	Broadband \$137B	Electricity \$100B	Public transit \$85B	Transportation inequities \$45B	Research and development \$180B	Workforce development \$100B	
				Ports* \$42B			
				Other \$30B			

Source: White House, Overview of "American Jobs Plan," as proposed, March 31, 2021

\*Airports, water transit, and ports

\$100 billion each for water, electricity, broadband, and education infrastructure. We view these provisions as the most likely to pass in a final package given overall strong bipartisan support, but the scope of the funding for these priorities remains a moving target. We also see a foreign policy angle to this aspect of Biden's infrastructure agenda that raises the political urgency around an infrastructure bill. The domestic manufacturing aspect of the proposal is directly aimed at securing the ability for the US to remain economically competitive with China. As such, Biden's strategy can be viewed as putting the US on the footing to sprint ahead, rather than hold China back, through economic policy. Biden's proposal seeks significant investment (around \$250 billion) in domestic research and development of next-generation technologies. Specific sectors targeted for funding are semiconductor manufacturing, as well as clean energy technologies including: energy storage, carbon capture, hydrogen, advanced nuclear, rare earth separation, wind, and biofuel. Expect this to be a significant selling point by the administration as it looks to secure bipartisan support for Biden's infrastructure agenda.

The second phase of Biden's policy reforms — the American Families Plan (AFP) — focuses more on social programs with around \$1.8 trillion in spending and tax credits. Broadly, the plan envisions \$500 billion toward education and around \$450 billion for childcare programs and paid leave. The plan also proposes extending the expanded Child Tax Credit (CTC) under the American Rescue Plan through 2025, tying it to the expiration of the personal tax code provisions of the 2017 tax law. However, there are potential issues

with the education, childcare, and expanded leave provisions in the AFP under reconciliation rules, as these may be viewed more as policy provisions than spending/revenue. As such, we view the bulk of the programs under the AFP as more politically challenging to work into a final package, thus they are more likely to be Democratic campaign proposals tied to the 2022 midterms.

Overall, we view the two plans as a menu of policy options for lawmakers to debate and advance in a legislative package. We see the most likely final bill having a core focus on traditional infrastructure, tied to several AFP priorities – most likely an extension of the CTC and some new education funding. This brings the final spending total to the \$2 trillion to \$3 trillion range, depending on the final funding levels for individual provisions.

### EXPECT PROPOSED TAX CHANGES TO BE DIALED BACK

Much attention has focused on the proposed tax changes as revenue sources for Biden's infrastructure priorities, which we broadly view as some of the most fluid aspects of ongoing negotiations. The ultimate corporate tax rate, adjustments to personal taxes for wealthy taxpayers, and the fate of state and local tax (SALT) adjustments continue to be the top issues of the tax debate in Washington. As we have previously highlighted, the revenue source with the most political support in Biden's infrastructure agenda is a higher corporate tax rate, but at a lower rate than the proposed 28%, likely in the 24-25% range. Moderate Democrats are reportedly uneasy with the political consequences of raising the capital gains rate to the proposed ordinary income



“We see the most likely final bill having a core focus on traditional infrastructure, tied to several priorities – most likely an extension of the Child Tax Credit and some new education funding. This brings the final spending total to the \$2 trillion to \$3 trillion range, depending on the final funding levels for individual provisions.”

rate of 39.6% for incomes above \$1 million with SALT caps in place, raising the chances that the capital gains rate change, if included, also trends lower. The balance is between three items on capital gains – the rate, step-up in basis, and implementation date. If compromise is found on the rate and step-up exclusion, the effective date could come earlier, as currently proposed by the Biden administration (retroactive to its announcement in April 2021). We expect continued emphasis on popular support for these corporate and individual tax changes by the Biden administration, but the current political dynamics highlight the difficulty of finding agreement among Democrats with very limited room to maneuver given the slim margins in both chambers of Congress.

We will specifically be watching dynamics among Democratic House lawmakers as the capital gains tax would be an even bigger hit to high-tax states with their own state-level capital gains charges, such as New York and California. Lawmakers from these states, especially in swing districts, are likely to see political blowback from their constituents. However, many are also concerned about primary challengers from the left. As such, support for a capital gains rate hike with some moderating adjustments to the current proposal would likely be the preferred policy path forward for these members. As it currently stands, Speaker Pelosi can only lose two votes to advance legislation, giving these lawmakers significant leverage to influence the tax debate.

### **REGARDLESS OF THE PATH FORWARD, THE OUTCOME WILL LIKELY BE THE SAME**

We expect volatile headlines over the course of the summer and into the fall on the specifics of an infrastructure deal, which could cause volatility in markets; however, our forest from the trees view is that the outcome is likely to be the same no matter the process going forward. There is a growing acceptance of around \$1 trillion in deficit spending tied to Biden's infrastructure priorities, and the legislative tools are there for Democrats to pass either a primary bill or a secondary bill with only Democratic support. As these pieces come into place, the debt limit will have to be raised later this fall, which will almost certainly have to be done via a reconciliation simple majority vote that could include additional infrastructure priorities. With Democrats seeing this as a once in a generation

opportunity to advance domestic investments, we are likely heading toward a \$2 trillion to \$3 trillion range final bill with some revenue-raising provisions as cost offsets. The least politically-sensitive revenue measures would target increased IRS enforcement (projected to capture around \$800 billion in missed federal revenue) and a higher corporate tax rate/tightened international corporate tax rules. As such, while we expect a robust debate on specific policy details into the fall, the politics of the infrastructure debate have likely already paved the road to be taken to a final bill later this year. ■

### **KEY TAKEAWAYS:**

- An infrastructure package in the \$2 trillion to \$3 trillion range, with about \$1 trillion in deficit spending, is likely by the end of this year or early next year.
- The most likely provisions to pass are funding for water, electricity, broadband, roads, bridges, transportation, and education infrastructure given strong bipartisan support, but the scope of the funding for these priorities remains a moving target.
- The domestic manufacturing aspect of the proposal is directly aimed at securing the ability for the US to remain economically competitive with China. Expect this to be a significant selling point by the administration as it looks to secure bipartisan support for Biden's infrastructure agenda.
- The second phase of the infrastructure agenda — the American Families Plan (AFP) — focuses more on social programs with around \$1.8 trillion in spending and tax credits. Broadly, the plan envisions \$500 billion toward education and around \$450 billion for childcare programs and paid leave.
- While we expect a robust debate on specific policy details into the fall, the politics of the infrastructure debate have likely already paved the road to be taken to a final bill later this year.



# Second Half 2021 Equity Outlook: Rally Normalizes; Backdrop Remains Strong

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

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

Rapid vaccinations (more than two-thirds of US adults have received at least one dose) have spurred a sharp reduction in daily new COVID cases and hospitalizations since the start of the year. This has resulted in a swift economic reopening which, boosted by enormous amounts of stimulus, is likely to push 2021 economic growth to its fastest pace in almost 40 years.

This economic momentum remains, with manufacturing and services surveys continuing to advance at very strong levels. In fact, the sharp rate of recovery is creating inflation concerns for investors as supply has been unable to meet this heightened demand. This dramatic demand versus supply imbalance could last for months, but we believe it should abate over time as stimulus ebbs and supply chains untangle. Productivity growth (due to economic digitization) should also help offset inflationary pressures, and S&P 500 corporate margin estimates continue to climb higher. Importantly, the Fed is expected to remain accommodative as the labor market recovery still has a way to go, and rate hikes will come because the economy is strong. The risk of over-tightening remains minimal.

We view the fundamental and technical backdrops as supportive over the intermediate term, and continue to see the positives outweighing the potential negatives.

## EARNINGS

The most important influence for equities over the long term is earnings, and this strong economic recovery is driving historically strong earnings growth. First quarter earnings season posted one of the strongest upside surprises in history with S&P 500 earnings growth finishing up 49% year-over-year (more than double the 21.6% consensus expectation). This is leading to markedly higher earnings revisions for 2021 and 2022, with upside to estimates remaining in our view. In fact, we believe S&P 500 earnings will hit \$200 in 2021 (45% growth year-over-year and ahead of the current \$190 consensus estimate). As earnings continue to recover, elevated valuation multiples should normalize in the back half of the year. The S&P 500 currently trades at a 25x P/E multiple (down from a 28x peak) which we believe will move directionally toward pre-pandemic levels (~22x) by year end. The upshot is that we do




not believe this normalization in valuation will outweigh robust earnings growth, providing further upside to equities – this \$200 earnings estimate and 22x P/E assumption results in a base case S&P 500 target of 4,400 by year end.

#### MARKET MOVING EVENTS

While equity market performance has been historically strong over the past year and we remain positive, it is normal for year two of a bull market to experience a moderation in its rate of ascent. Inflation, Fed communication, and the debate over stimulus/taxes are likely to gain significance in the back half of this year. These items (among many others) can lead to short-term volatility, something that has generally eluded equities in a broad sense following positive vaccine news in early November. The largest drawdown for the S&P 500 since then has been ~5%, while it is very normal (and healthy) historically to have 7-12% pullbacks throughout a year. We view the fundamental and technical backdrops as supportive over the intermediate term, and continue to see the positives outweighing the potential negatives; thus, we recommend using potential weakness as a buying opportunity. As has been the case for months now, volatility is likely to be seen more significantly beneath the surface as sector rotation continues to play out – leaving plenty of opportunity for active investors.

“First quarter earnings season posted one of the strongest upside surprises in history with S&P 500 earnings growth finishing up 49% year-over-year.”

#### 2021 Year-End Forecasts

	S&P 500	EPS ESTIMATE	P/E	PRICE
 <b>Bull Case</b>		\$210	23x	4,830
<b>Base Case</b>		\$200	22x	4,400
 <b>Bear Case</b>		\$190	20x	3,800

Source: Raymond James Equity Portfolio & Technical Strategy



## SECTOR POSITIONING

We continue to recommend a pro-cyclical stance to portfolio positioning, as the areas with increased leverage to the economic recovery are likely to outperform. However, we want to allocate in a fairly balanced, diversified way as well. This leads to our favored sectors being Financials, Industrials, Energy, Consumer Discretionary, and Communication Services. We see the Financials sector benefitting from strong balance sheets and favorable credit trends, along with the likelihood of higher interest rates and loan growth as the economy rebounds, supporting fundamental momentum from attractive valuations (lowest P/E on 2022 estimated earnings of all sectors). The Industrials sector provides leverage to the global manufacturing recovery, along with replenishing inventories from exceptionally low levels. Additionally, the sector is a direct beneficiary of the infrastructure stimulus package currently being negotiated in Congress. The Energy sector is seeing a turnaround in fortunes due to higher oil prices, as recovering demand from a (mostly) reopening world outstrips the industry's disciplined approach to production and capital spending. Spot oil prices recently moved to multi-year highs of over \$70/barrel, above January 2020 levels, while the price of the Energy sector is still below

pre-pandemic levels. Consumer Discretionary is a bifurcated sector with varying degrees of 'stay-at-home' and 'recovery' leverage. We favor the equally-weighted sector (or 'average stock') which is benefitting from enormous stimulus. High savings rates and an improving jobs market are tailwinds for consumer spending as the economy swiftly reopens. Like Consumer Discretionary to a degree, we continue to appreciate the Communication Services sector's mix of structural growth along with leverage to the economic recovery. Accelerated connectivity needs/uses in today's environment, along with the 5G rollout, are fundamental tailwinds. On the flip side, we recommend underweight exposure to the more 'defensive,' interest-sensitive areas (i.e., Utilities and Consumer Staples) due to our favorable stance on the fundamental trajectory, along with the likelihood of higher interest rates over the next 6 to 12 months.

## GROWTH VS. VALUE

We favor value over growth with new money, and recommend building exposure as relative momentum builds over time. Historically, style preferences have moved in long-term trends with growth outperforming until the dot-com bubble, value outper-

## Sector Views

### OVERWEIGHT:



Consumer  
Discretionary



Financials



Communication  
Services



Industrials



Energy

### EQUAL WEIGHT:



Technology



Health Care



Materials



Real Estate

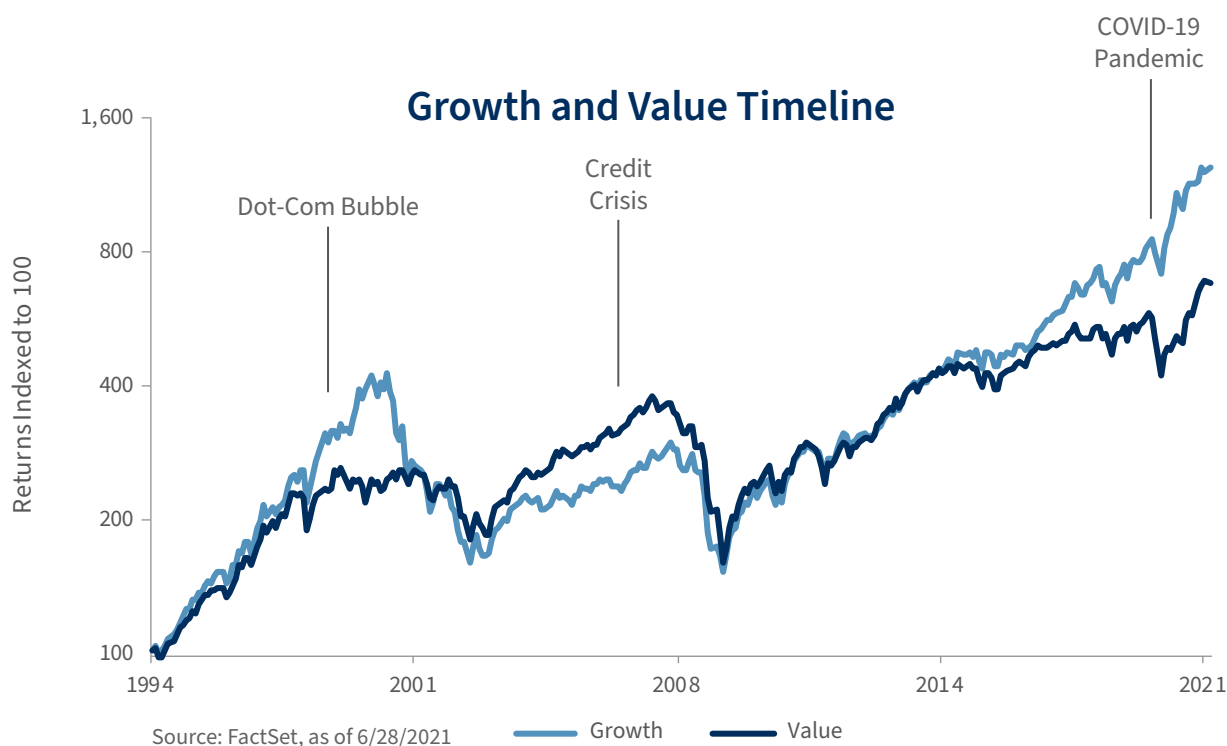
### UNDERWEIGHT:



Consumer Staples



Utilities



forming from then until the credit crisis, and growth taking back over for the past decade-plus bull market. Growth's outperformance then reached a height during the early stages of the pandemic as the secular trajectory of technology use was accelerated in the stay-at-home environment. At the same time, interest rates moved to all-time lows, allowing for elevated valuations.

However, since the positive vaccine news in early November provided a 'light at the end of the tunnel' for investors, interest rates have generally moved higher and there has been a dramatic shift toward short-duration (cyclical) growth versus secular growth. Even so, the S&P 500 Value Index still trades at the low end of its historical relative valuation range versus growth with more fundamental leverage to the economic recovery.

Additionally, our sector preferences skew toward value, as Financials are the largest relative weighting for value, followed by Industrials and Energy. On the other hand, growth has outsized exposure to the Technology-oriented areas which are generally being used as a source of capital for this rotation. Moreover, value should be a relative beneficiary of the current stimulus/tax discussion in DC, along with higher interest rates over time. The jury is out on whether or not value will take over as a long-term outperformer (due to a still strong fundamental trajectory from Technology), but we do believe it can continue market leadership in the back half of 2021. ■

“ We believe value can continue its market leadership in the back half of 2021. ”

#### KEY TAKEAWAYS:

- The most important influence for equities over the long term is earnings, and this strong economic recovery is driving historically strong earnings growth.
- While equity market performance has been historically strong over the past year and we remain positive, it is normal for year two of a bull market to experience a moderation in its rate of ascent.
- We continue to recommend a pro-cyclical stance to portfolio positioning, as the areas with increased leverage to the economic recovery are likely to outperform.
- We favor value over growth with new money, and recommend building exposure as relative momentum builds over time.



## Q&A: Inflation

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

### Setting the stage:

The Federal Reserve's (Fed) legislated dual mandate is price stability and maximum sustainable employment. It defines price stability as 2% inflation as measured by the Core Personal Consumption Expenditures (PCE) Price Index. In August 2020, the Fed formally revised its monetary policy framework to an average inflation-targeting system. Following a period below the 2% long-term target (as has been the case for the last several years), the Fed will pursue a period of inflation moderately above 2%, while leaving the longer-term goal intact.

This policy change is a significant departure from past decades, where the Fed would act preemptively to prevent inflation from rising. The view had been that if inflation were allowed to pick up, inflation expectations would also rise, reinforcing higher inflation, which would add to inflation expectations, and so on. This was the primary explanation for the high inflation of the 1970s and early 1980s. The change reinforces the notion that 2% is a goal, rather than a ceiling on inflation.

**Q:** Why does the Fed say there's no inflation when the price of everything I buy is going up?

**A:** Fed officials are not disputing the fact that inflation has picked up, but it is important to remember that your personal rate of inflation may differ from what the Fed targets when setting monetary policy. The Fed is concerned about sustained increases or decreases in the overall level of prices in the economy. It is not focused on the price of a single good or service. Consumers tend to notice price increases right away, particularly for food and gasoline prices, but they don't often see places where inflation is low or negative (bought a large-screen TV lately?). Prices of most goods and services are raised

periodically – so you see the increase all at once rather than over time. The media can also play a big part in fanning inflation fears- just look at the nightly news lately.

While consumer price inflation is now above the 2% target on a year-over-year basis (5.0% for the 12 months ending in May 2021), the Fed believes that the increase is due to transitory factors. One of which is called 'base effects' — inflation was low during last year's lockdowns (the CPI rose just 0.1% for the 12 months ending May 2020) and prices are rebounding as the economy returns to normal. Another transitory factor is restart pressures, such as supply chain disruptions and materials shortages. Restart pressures occur in every economic recovery,



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“The key question is whether inflation expectations rise further and whether that increase will be sustained.”

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but are more intense now due to the speed of the economic recovery. Fiscal policy has been larger than was anticipated at the start of the year and vaccinations have arrived quicker. The surge in economic growth caught some producers flat-footed. February's severe weather delayed supplier deliveries and the pandemic has had a continued impact on foreign trade, made worse by container shortages and higher shipping costs.

**Q: How long is transitory?**

**A:** There is no precise time period, but most inflation pressures should not be permanent. Base effects will continue for a few months, fading by late summer. Supply chain bottlenecks and input shortages may not be resolved as quickly and could put upward pressure on inflation beyond this year, but they will clear up eventually.

Labor market frictions will be more intense than in a typical economic recovery. Matching millions of unemployed workers to available jobs will be challenging. Schools and daycare facilities will reopen in the fall, which should lead to an increase in labor force participation; however, many older workers opted for early retirement during the pandemic and may be reluctant to re-enter the labor force.

Fiscal policy will remain supportive into 2021, but less so, becoming a drag on economic growth (offset partly by a recovery in private-sector demand). The increase in household savings, built up during the pandemic, should support consumer spending growth in the near term, but will be depleted over time. Economic growth is expected to moderate into next year, helping to reduce inflation pressures.

**Q: Why are some economists (including former Treasury Secretary Larry Summers) more concerned about inflation than others?**

**A:** Economists (including those at the Federal Reserve) believe that inflation expectations play a key role in the inflation process. As inflation expectations rise, workers are more likely to

demand higher wages and businesses are more likely to try to raise prices, thus higher inflation expectations can often be self-fulfilling.

Market-based measures of inflation expectations, such as 'breakeven inflation' (the spread between inflation-adjusted Treasuries and their fixed-rate counterparts) have crept higher. Survey-based consumer expectations of inflation have also risen. The key question is whether inflation expectations rise further and whether that increase will be sustained. Recently, measures of inflation expectations have begun to moderate.

Some economists, including former Treasury Secretary Larry Summers, are concerned that the unprecedented amount of fiscal stimulus will boost aggregate demand enough so that it continues to outpace supply. Under this scenario, inflation pressures won't recede, leading to a sustained increase in inflation expectations (and higher actual inflation). Biden administration economists (and others) disagree — believing that supply chain issues will be resolved and inflation expectations will remain well-anchored.

**Q: Why does the Fed exclude food and energy? Don't you and I have to buy gasoline and groceries?**

**A:** The Fed does consider food and energy prices in its inflation outlook; however, since food and energy prices tend to be volatile, economists focus on the core measure to get a better sense of the underlying trend in inflation. There are a variety of other ways to measure core inflation, such as excluding the large price increases and the large price declines each month or by simply looking at the median price increase; however, excluding food and energy prices is the most common.

**Q: Money supply measures have surged during the pandemic. Won't this lead to higher inflation?**

**A:** Economists are taught that inflation is “always and everywhere a monetary phenomenon” — too much money chasing too few

“ ... should this risk manifest, we have the tools and the experience to gently guide inflation back to our target — no one should doubt our commitment to do so.”

goods and services — but the various monetary aggregates are not a useful gauge for inflation.

M2, which is the most liquid form of money (currency, savings and checking accounts, small time deposits, and retail money market funds), rose sharply in the early part of the pandemic and has continued to move higher. Households have increased their savings and banks have been accumulating reserves (which the Fed now pays interest on). Through its large-scale asset purchases (quantitative easing, or QE), the Fed has pumped reserves into the banking system, but that's only inflationary if consumers borrow excess reserves from the banks and spend. That's not what's happening. The rise in M2 has more to do with the pandemic (increased demand for liquid assets) than with Fed policy (which has acted to meet the demand for liquid assets).

**Q:** What if the Fed is wrong and inflation does rise on a sustained basis?

**A:** If higher inflation is sustained, the Fed can always tighten policy through a reduction in the monthly pace of asset purchases or by raising short-term interest rates sooner than expected. Under this scenario, economic growth would slow, perhaps more than intended. Soft landings are difficult.

In a recent speech, Fed Governor Lael Brainard said “a persistent material increase in inflation would require not just that wages or prices increase for a period after reopening, but also a broad expectation that they will continue to increase at a persistently higher pace.” The Fed will be closely monitoring the incoming data, “attentive to the risk that what seem like transitory inflationary pressures could prove persistent.” However, Brainard stressed that “should this risk manifest, we have the tools and the experience to gently guide inflation back to our target — no one should doubt our commitment to do so.” ■

### Inflation - What the Fed Considers

It is important to point out that the Fed will adjust policy based off of its inflation metrics, not those that are directly felt by consumers. In fact, Fed inflation benchmarks are not impacted by rising asset (e.g., equities, bitcoin), housing, or energy prices. It is unlikely that the recent surge in these prices will impact the Fed's thinking regarding raising interest rates.

	Main Street	Wall Street
Equities	✓	✗
Cryptos	✓	✗
Energy	✓	✗
Food	✓	✗
Housing	✓	✓
Building Costs	✓	✓
Apparel	✓	✓

## Economic Snapshot

The US economic recovery should remain strong as the pandemic recedes, with a shift in consumer spending (from goods to services). Job growth should be robust, but the usual labor market frictions will be amplified by the speed of recovery. Higher inflation should be transitory, moderating as supply bottlenecks clear up, but pressures could be more severe and last longer, possibly leading to a sustained increase in inflation expectations. The Fed is not expected to raise short-term interest rates for some time, but is likely to taper the monthly pace of asset purchases later this year or in early 2022.

**DR. SCOTT BROWN**  
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	Led by a recovery in consumer services and supported by further vaccination progress, GDP growth is expected to be strong in the near term. Labor market frictions may be a constraint.
	EMPLOYMENT	Nonfarm payrolls are still down about 9.5 million from the pre-pandemic trend, but we should see strong gains near term. Matching millions of unemployed workers to millions of available jobs will likely be challenging.
	CONSUMER SPENDING	Consumer spending on services should continue to improve, while spending on consumer goods (which had been unexpectedly strong thorough the pandemic) is likely to moderate.
	BUSINESS INVESTMENT	Capital goods orders and shipments exhibited a strong trend in early 2Q21, supported by business optimism. Business structures are expected to remain relatively soft, but should improve.
	MANUFACTURING	Growth in new orders has remained strong. Supply chain constraints should continue to ease, helping to improve supplier deliveries.
	HOUSING AND RESIDENTIAL CONSTRUCTION	Work-from-home has led to strong demand. Supply constraints have limited new construction and the pace of home sales. Higher prices have reduced affordability, so a pause may be in order.
	MONETARY POLICY	Short-term interest rates may be raised a little earlier than previously expected, but not anytime soon. The pace of monthly asset purchases is likely to be tapered later this year or in early 2022.
	FISCAL POLICY	Fiscal support will continue, but the impact on growth will fade over time. Lawmakers should eventually work to put the budget on a long-term sustainable trajectory, but not anytime soon.
	REST OF THE WORLD	Still a mixed bag. The spread of the virus and the distribution of vaccines will vary widely.
NEUTRAL	INFLATION	Inflation has picked up, reflecting base effects (a rebound in prices that were depressed a year ago), restart pressures (supply chain bottlenecks and materials shortages), and higher prices of used vehicles. However, these pressures are expected to be transitory.
	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.
	THE DOLLAR	The trade deficit widened during the pandemic and in the initial recovery, putting some downward pressure on the dollar. While Fed tightening is far off, we may see an increase sooner, a positive for the dollar.



## Sector Snapshot

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

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

formulate a strategy customized to their preferences, needs, and goals.

These recommendations will be displayed as such:

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

**Equal Weight:** expect in-line relative performance

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

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

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

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	CONSUMER DISCRETIONARY	12.3%	We remain Overweight in the Consumer Discretionary sector with a bias toward the equal-weight index (or 'average stock'). We view the consumer as being in good shape with still elevated savings rates, low interest rates, and a jobs recovery ahead. The sector stands to benefit from this pent-up demand in the reopening (supported by unprecedented amounts of stimulus).
	FINANCIALS	11.2%	We remain Overweight the Financials. Strong balance sheets and favorable credit trends, along with the likelihood for higher interest rates and loan growth as the economy rebounds, support fundamental momentum within the sector. Additionally, valuation is attractive with relative P/E and P/Book multiples at the low end of their historical ranges. A moderation in the rise of interest rates lately has corresponded with consolidations for many stocks in the sector, which we view as a buying opportunity.
	COMMUNICATION SERVICES	11.2%	We continue to favor the Communications Services sector. We appreciate the sector's mix of structural growth along with leverage to the economic recovery. Increased connectivity needs/uses in today's environment along with the 5G rollout are fundamental tailwinds, while relative valuation remains attractive (at the low end of its historical range).
	INDUSTRIALS	8.5%	We remain Overweight the Industrials. Robust demand in the economic recovery has been unable to be matched by supply. This supply/demand imbalance is leading to pricing power for the sector, and very low inventories will need to be replenished as supply chains unknot over time. The result is fundamental momentum that should also catch a boost from infrastructure stimulus (currently being negotiated in Congress).
	ENERGY	2.8%	We recently upgraded Energy to Overweight. The rebound in oil prices – over \$70/barrel currently and up 50% since the year began – is a boon for Energy companies. Also, the industry's disciplined approach to production and capital spending is resulting in shareholder-friendly uses for substantial free cash flow growth. Additionally, following over a decade of underperformance, the sector represents less than 3% of the S&P 500 (still near record lows).
EQUAL WEIGHT	INFORMATION TECHNOLOGY	27.2%	We recently downgraded the Technology sector to Equal Weight. Fundamentals remain strong and there is no questioning the acceleration of secular growth trends created by the 'stay-at-home' environment. However, valuation had reached lofty levels and as interest rates have risen, the sector has acted as a 'source of capital' for the rotation into other areas. We believe this dynamic likely continues for now, and do not believe Technology is ready to regain market leadership yet.
	HEALTH CARE	13.1%	We maintain our Equal Weight recommendation for Health Care. The 'defensive' sector offers attractive valuation and consistent earnings growth, but an unfavorable political environment (drug pricing) and more attractive fundamental momentum in other sectors serve as offsets.
	MATERIALS	2.6%	The Materials sector is a beneficiary of global stimulus, the manufacturing recovery, and infrastructure spending in the US. Despite strong gains, relative valuation remains reasonable in our view. However, the US dollar remains a significant influence and has bounced sharply from its lows following the recent FOMC announcement. We remain Equal Weight, as the sector moderates its rate of ascent and these cross-currents play out.
	REAL ESTATE	2.6%	We recently upgraded Real Estate to Equal Weight. We could no longer ignore the positive relative price strength of the sector now that earnings revisions are gaining positive momentum (and relative valuation was at 15-year lows). With many subsectors of real estate set to benefit from the economic reopening, our previous Underweight recommendation no longer seemed justified.
UNDERWEIGHT	CONSUMER STAPLES	5.9%	We maintain our Underweight recommendation to Consumer Staples. As the world reopens, the more cyclically-oriented sectors will post robust earnings growth, while earnings growth for the defensive Consumer Staples sector should remain in the single digits. Additionally, many companies in this sector may feel margin pressures as they cannot raise prices rapidly enough to offset the higher costs.
	UTILITIES	2.5%	We remain Underweight Utilities. The slow growth, defensive sector is likely to underperform in our view as the economic environment recovers and interest rates grind higher.

## DISCLOSURE

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

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

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

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

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

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

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

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only

form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

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

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

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

The process of rebalancing may result in tax consequences.

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

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

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

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

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