

# INVESTMENT STRATEGY QUARTERLY

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# Letter from the Chief Investment Officer

## Ten Themes for 2020

As someone who needs glasses, I know firsthand that 20/20 vision and the ability to experience the beauty and clarity of life is amazing. As we embark on the start of a new year, clarity and foresight is exactly what investors are seeking, especially with the daily dose of unprecedented headlines we receive. In hindsight, the guidance our team of economists, strategists, and portfolio managers gave last year proved prescient as ~90% of our ten themes for 2019 were accurate. Despite the success, we will not rest on our laurels as 2020 is likely to prove more challenging. By disseminating our bird's eye view on the US economy and various asset classes, we hope to provide investors with a sharp, reliable lens to help bring their portfolio decisions into focus ...

### #1: Keeping a Close Eye on the Economy

The state of the economy is of the utmost importance when evaluating the return potential of the major asset classes. We forecast that US GDP growth will be moderate at 1.7%, but that the current record-setting economic expansion will continue unabated at least through the presidential election. A resilient labor market, robust consumer spending, and a rebound in global growth should be supportive. Although it is rare for recessions to begin in an election year, multiple dynamics will cause us to sharpen our pencils when assessing the economy post-election. Our real-time economic indicators suggest a small probability of a recession over the next twelve months, so keeping a close eye on them will be crucial should the economy meaningfully weaken.

### #2: The Fed's Corrective Surgery

When the US economic outlook was clouded by trade tensions and slowing global growth, the Federal Reserve (Fed) performed corrective surgery in the form of three 'insurance' rate cuts. Those actions recalibrated Fed policy and have extended the duration of the expansion thus far. Knowing that the impact of monetary policy lags, and given that the Fed has limited ammunition with the fed funds target rate at 1.50-1.75%, we do not anticipate interest rates will be altered in 2020. The ongoing expansion of the Fed balance sheet will provide stealth easing as it provides further liquidity.

### #3: Tunnel Vision on the US Presidential Election

Until November 3, investors will have tunnel vision when it comes to US politics. While Congressional gridlock (Republican Senate, Democratic House) continues to be the likely outcome, uncertainty remains at the top of the ticket. The determination of the Democratic candidate may last well into the summer with an increasing probability of a 'brokered convention' – the first for the Democratic Party since 1952 – the longer the process lasts. If history serves as a precedent, positive economic data leads to a favorable outcome for the incumbent. But given the level of division across the country, the election may be determined by two key swing states: Pennsylvania and Wisconsin.

### #4: A Magnified Look at the Bond Market

Investors searching for yield may need to look through the magnifying glass, as global yields and spreads remain near record lows and continue to reduce the upside return for the bond market overall. Due to more moderate US growth, muted inflation, international demand, and favorable demographics, we do not expect the 10-year Treasury yield to move significantly over the next twelve months (year-end target: 1.75%). While credit market spreads will widen slightly, we do not think this will negate the positive performance of our favored sectors—investment grade and emerging market bonds.

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“ We always encourage investors to keep their eyes on the prize and follow a well-thought out financial plan ... .”

## #5: See the Bigger Picture for US Equities

Following the best year for US equities since 2013, investors need to see the bigger picture. The macroeconomic backdrop remains supportive with muted risk of a recession, easing financial conditions, and lower interest rates. 2019 performance was largely driven by P/E expansion, but 2020 should renew the emphasis on earnings growth, which we forecast at 5%-6%. History will play a role too, as election years have been historically positive for the equity market. Since 1936, in presidential election years, the S&P 500 has rallied 9% on average and was positive 86% of the time. In the case of no recession (our forecast), the trend is more impressive with an average return of 10.7% and positive 94% of the time. Our base case is that the S&P 500 will notch new highs and rally to ~3,350 by year end.

## #6: Double Vision of Favorite Sectors

We still favor cyclicals over defensives, with four of our five favorite sectors being Information Technology, Communication

Services, Financials, and Industrials. Our lone defensive choice is Health Care, which lagged the broader market in 2019 due to political risk. This sector selection has us seeing double, as a bias towards these sectors is inherently beneficial to small-cap stocks. From both a market capitalization and revenue perspective, small cap carries its highest exposures and weightings towards these same sectors.

## #7: Near & Far Sights for Technology Sector

We envision the technology sector being a stand out again this year. Our near sights are focused on earnings visibility, which remains strong with the anticipated rollout of 5G. The transition from 4G to 5G is the largest enhancement in wireless technology in a decade, so our far sights believe this will be a multi-year catalyst for everything from semiconductors to phone carriers. The benefits should permeate across other industries, keeping demand for new technologies, applications, services, and software resilient.

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

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

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### #8: Blurred Vision for International Equities

Our preference for US equities over international equities was a relatively easy choice over the past several years. However this year, the line between the two is beginning to blur. A possible bottoming in Europe's economic data, attractive valuations on a relative basis, an acceleration in earnings growth, and the possibility of substantial fiscal stimulus packages (especially in Germany) have the potential to propel international equities moving forward. We maintain our view on emerging markets as an appealing allocation for long-term investors.

### #9: A Panoramic View of the Dollar and Oil

After rallying six times in the last seven years, a further broad based rally in the US dollar is unlikely. A Fed on hold, decelerating US economic growth and burgeoning twin deficits will likely keep a stronger dollar out of view. A stable, slightly weaker dollar is a positive for commodities. Specifically, we believe that oil prices will recover to six-year highs by the end of 2020 and rally to \$65/barrel. Our expectation that global oil demand will grow slightly faster in 2020 than 2019 (and mark 11 consecutive years of growth) is supportive of this view. Furthermore, the slow upward movement in oil prices has exerted pressure on the capital budgets of US oil and gas companies which should translate into a sharp slowdown in US oil production.

### #10: Volatility is Hiding in Plain Sight

With 2019 being the best year for US equities since 2013 and aggregate bonds since 2002, investor complacency and elevated expectations are evident. However, with relatively more expensive markets versus last year, volatility is hiding in plain sight. From trade wars to impeachment, and from growth concerns to geopolitical tensions, there is no shortage of headline risk for 2020. The burden remains on us to decipher if, and when, any of these headlines alter our economic or asset class views in a demonstrable fashion. Increased volatility and the aging bull market make selectivity at the regional, sector, and individual stock level even more important.

We always encourage investors to keep their eyes on the prize and follow a well-thought out financial plan that tailors an appropriate asset allocation in light of specific investment objectives and risk tolerance. While we provide our lens in which to view the economy and various asset classes, your advisor can provide further insights into your portfolio as they have the depth perception needed to understand your comprehensive financial situation, the peripherals needed to account for risks to your plan, and the ability to add some color. ■



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





# Charting the Course for the 2020 Elections

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

2020 kicks off an election campaign cycle that will determine the trajectory of the Trump policy agenda and its associated impact on the market. We believe Trump's reelection campaign will center on a message of positive economic and market performance — a virtual necessity from a historical standpoint for the reelection of an incumbent president. Democrats will be looking to see if they can continue the momentum from the 2018 and 2019 elections, where suburban voters have swung away from Republicans and toward Democratic candidates.

## THE PROOF IS IN THE NUMBERS

Before we get to the general election, Democrats will first need to choose a nominee, which could lead to increased volatility in the first half of 2020. With a large field of candidates swapping front-runner status and party rules that disburse delegates on a proportional basis, there is an elevated probability that none of the candidates are able to achieve a majority of delegates prior to the convention. Alternatively, the battle to win the majority could reinforce some divisions within the Democratic Party. Should Democrats fail to produce a candidate that the party can rally behind, or should a contested primary process give rise to a legitimate third party candidacy, both could be seen as benefiting the reelection chances of President Trump.

While the race for the presidency will dominate the headlines, the ultimate market and economic impact will be decided based upon the outcomes of the majorities in the House and Senate.

While the race for the presidency will dominate the headlines, the ultimate market and economic impact will be decided based upon the outcomes of the majorities in the House and Senate. The ability for any candidate to enact his or her agenda, especially through the confirmations of key cabinet and regulatory posts, runs through the Senate.

In the Senate, Republicans will be on the defensive as they are defending 23 of the 35 seats on the ballot in 2020, but are viewed as being well-positioned given the geographical distribution of races. Democrats will need to net three or four seats, depending upon the outcome of the presidential election, to win the majority. Adding significant intrigue to the Senate fight is the future of the filibuster, which maintains a 60 vote (out of 100) threshold for the passage of legislation. Should either party control the House, Senate, and presidency, we expect a significant debate on lowering the threshold to a simple majority. This becomes more likely if the Democrats are able to secure a two-three seat edge in the Senate, which would increase the probability of major reform passing into law.

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“ Democrats will first need to choose a nominee, which could lead to increased volatility in the first half of 2020.”

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In the House, Democrats built a solid majority in the 2018 mid-term elections and Republicans would need to net 20 seats for the House to flip. Recent Republican retirements point to more potential pickup opportunities for Democrats, a sentiment that indicates rank and file members believe Democrats will maintain their majority after the 2020 election. However, Republicans have plenty of pickup opportunities themselves, given that 31 Democratic incumbents are from a congressional district that President Trump won in 2016.

#### **RACE FOR THE DEMOCRATIC NOMINATION – LIBERALS AND MODERATES GO HEAD TO HEAD**

The Democratic race appears to be coalescing into a two faction race – moderates (led by Joe Biden and Pete Buttigieg) vs. the liberal wing (led by Bernie Sanders and Elizabeth Warren). While countless external events can and will happen between now and election day, we believe that the market under-appreciates a liberal candidate’s ability to capture the nomination and win the presidency. We believe market volatility is likely to reemerge, should a candidate from the liberal wing start to pick up delegates (especially given that any candidate who wins the nomination, by definition, has a solid chance of winning the presidency).

However, a resurgence of the moderate wing is an emerging storyline as we inch closer to the first primary votes in Iowa in early February. As of December, Joe Biden leads the national polls, and Pete Buttigieg has risen to first place in polling in the first primary states (Iowa and New Hampshire). Concurrently, two late contenders have recently entered the race that further boost the moderate lane – Michael Bloomberg and Deval Patrick. The entrance of Bloomberg and Patrick is a clear manifestation of concerns that Biden cannot ultimately win the nomination, in addition to the potential emergence of a ‘Never Warren/Never Sanders’ contingency. Bloomberg will not have Biden’s money

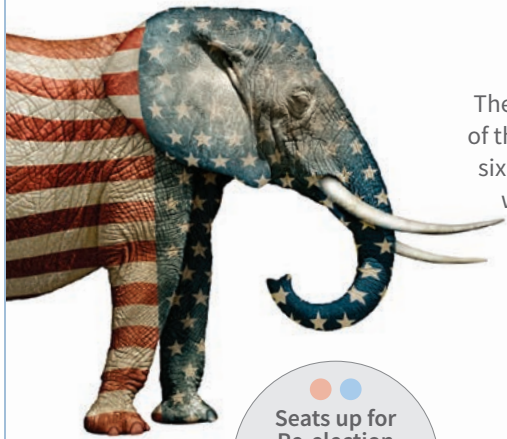
issues and both Bloomberg and Patrick will try to undercut Biden in the ‘logical liberal’ lane during the primary. That said, Biden is still leading in many national polls and has little incentive to exit.

The entrance of two new moderate-leaning candidates will only further split the moderate/slightly liberal vote. In addition, the entrance of another billionaire will allow Warren to keep the message on the disparity between the wealthy and the ‘rest of us’ and away from Medicare for All. A potential complication for a liberal nominee is the continued strength of Senator Sanders among the liberal wing of the Democratic Party. A united Warren-Sanders front could be necessary for either to capture the nomination.

#### **THE SECRET LIES WITH THE SENATE**

35 total seats are up for grabs in 2020. Republicans currently hold a 53-47 majority, which sets up Democrats for an uphill battle in order to make significant gains. Of the 35 races, 11 are currently considered ‘safe’ Democratic and 18 ‘safe’ Republican. This leaves only 6 ‘competitive’ seats. The last time that control of the House or Senate flipped during a presidential election year was in 1980. Much attention will focus on the six races currently deemed to be most competitive and most likely to change party control. In our assessment, the seats most at risk in order of their potential to flip are as follows: 1. Alabama (D); 2. Colorado (R); 3. Arizona (R); 4. Maine (R); 5. North Carolina (R); and 6. Iowa (R).

The increasingly polarized political climate has generated greater emphasis on party affiliation/overlap between the outcome of the Senate and presidential elections in individual states. In 2016, for the first time since the direct election of Senators, 100% or 34 of 34 Senate races matched the state’s preference in the presidential election. This is a dramatic shift over the last several decades when as recently as the 1988 presidential elections, 50% of the Senate races did not match the presidential preference of the



## The Senate

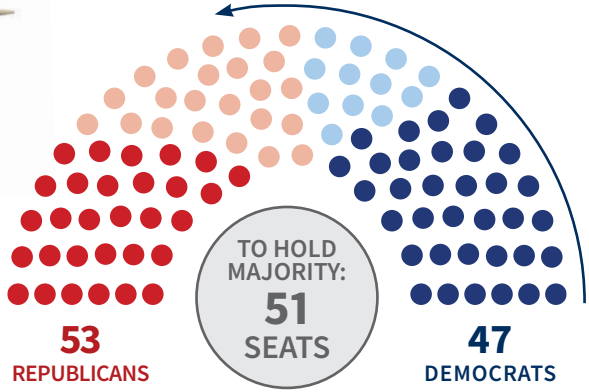
The Republicans currently hold the majority. One third of the Senate is up for reelection in 2020. Of these seats, six are considered to be competitive seats. Democrats would need to net four seats to secure a majority.



●● Seats up for Re-election

**6 Competitive Seats**

Alabama	Maine
Colorado	North Carolina
Arizona	Iowa

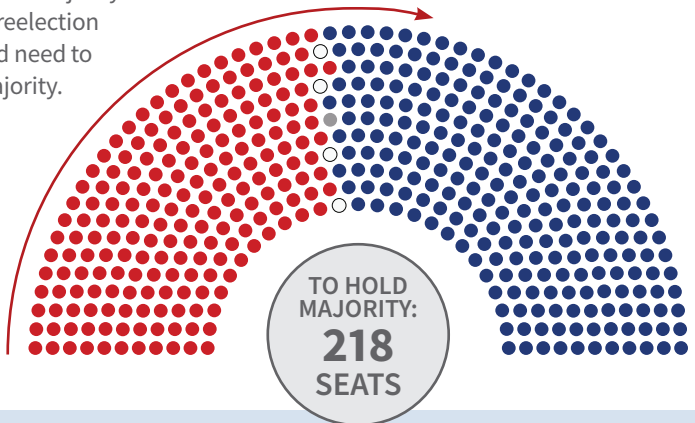


**4 SEATS NEEDED**  
for Democrats to flip control

## The House of Representatives

Democrats currently hold the majority. The entire House is up for reelection in 2020. Republicans would need to net 20 seats to secure a majority.

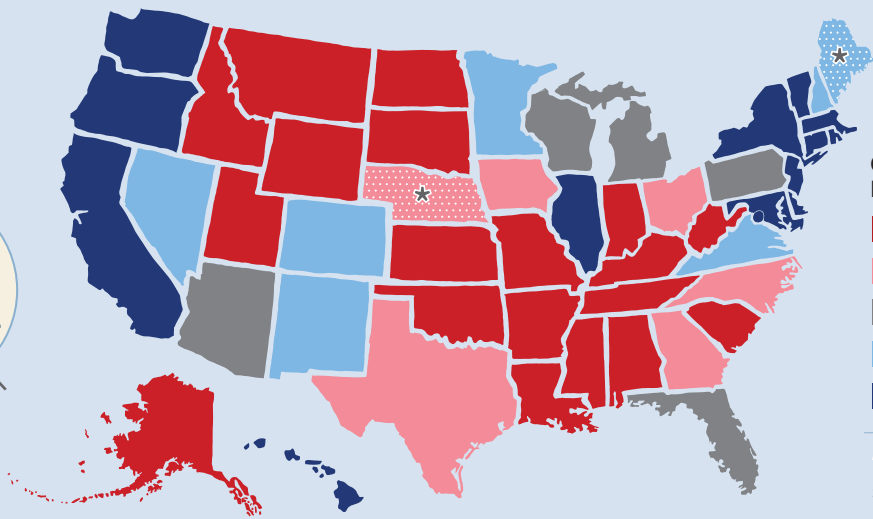
**20 SEATS NEEDED**  
for Republicans to flip control



## The Presidential Election



**270 ELECTORAL VOTES**  
Needed to Win



**GENERAL ELECTION MAP**

- Solid Republican
- Leans Republican
- Toss-up
- Leans Democratic
- Solid Democratic

★ Congressional District Method  
Source: Raymond James Equity Research



“The increasingly polarized political climate has generated greater emphasis on party affiliation/overlap between the outcome of the Senate and presidential elections in individual states.”

state. This could partially explain the outcome of the 2018 mid-term Senate elections in which Democrats won a majority in the House, but Republicans were able to flip the Senate seats of incumbent Democrats in North Dakota, Missouri, Indiana, and Florida – all states won by President Trump in 2016. Democrats were able to pick up a seat in Nevada (Clinton win) and Arizona (narrow Trump victory). In light of this factor, Arizona and North Carolina are set to be highly competitive given that Trump’s 2016 victory in those states came with less than 50% of the vote. Doug Jones (D-AL) (Trump +27.7%), Cory Garner (R-CO) (Clinton +4.9%), and Susan Collins (R-ME) (Clinton +2.9%) could also get caught up in the national trend.

The top-tier candidate status of Senators Elizabeth Warren (Massachusetts) and Bernie Sanders (Vermont) may have a significant impact on the Senate math should they be elected as either president or vice president. Massachusetts and Vermont do not require a replacement to be of the same party as the outgoing Senator, meaning the current Republican Governors of both states could appoint a Republican interim replacement – taking away a Democratic seat until the special elections conclude. This could have important consequences on cabinet appointments and an initial legislative agenda as late as five months into the first term of a potential Democratic administration (if the Democrats net a thin majority in the Senate). Per Massachusetts state law, the outgoing Senator files a letter which triggers a 145-160 day period (roughly five months) until a special election is held for a replacement and the governor makes an interim appointment to fill the vacated seat. Vermont’s special election is held within three months of the vacancy.

At this time, we believe the most likely scenario for the Senate is a continued Republican majority, but the stable national support

for impeachment and the strength of the candidacies of Senators Sanders and Warren (and their accompanying policy positions) should direct more attention on these elections. Going back to 2006, the most competitive races in presidential years have gone decisively in favor of one party in the range of 73-80%. If the 2020 cycle continues the 2018 trend of a Democratic ‘wave’ election and 80% of the current competitive Senate races are won by Democrats, this produces a 51-49 Democratic Senate. The Senate factor will have important market implications in the event of a change in administration post-2020, and could serve to temper or amplify market concerns around more impactful legislation finding a path to becoming law. ■

#### KEY TAKEAWAYS:

- While the race for the presidency will dominate the headlines, the ultimate market and economic impact will be decided based upon the outcomes of the majorities in the House and Senate.
- The ability for any candidate to enact his or her agenda, especially through the confirmations of key cabinet and regulatory posts, runs through the Senate.
- 35 total Senate seats are up for grabs in 2020. Republicans currently hold a 53-47 majority, which sets up Democrats for an uphill battle in order to make significant gains. Of the 35 races, 6 are considered ‘competitive.’
- At this time, we believe the most likely scenario for the Senate is a continued Republican majority.





# 2020 Economic Outlook: Stability with a Chance of Slowdown

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

The US economy is expected to expand moderately in 2020. Many of the 2019 uncertainties seem likely to continue into the first half of the year, but the downside risks to the growth outlook appear to be less worrisome than they did in the summer. Consumer spending is likely to grow at a moderate pace, supported by job gains and wage growth, but limited by slower growth in the labor force. Business fixed investment is likely to be mixed and somewhat restrained, but we ought to see some general improvement. Federal Reserve (Fed) policy is expected to remain on hold until we get a material change in the economic outlook.

Job growth, while uneven, slowed in 2019, reflecting a tighter job market. Firms continue to report difficulties in finding skilled workers. The unemployment rate fell to a 50-year low. Demographic changes (an aging population, slower growth in the working-age population, reduced immigration) imply that the workforce will grow at about 0.5% per year over the next ten years, slower than in previous decades. Workers are also consumers, so the potential upside on consumer spending growth is likely to be limited (labor force growth of 0.5% plus productivity growth of 1.0-1.5% gets you a potential GDP growth rate of 1.5-2.0%).

Trade policy uncertainty and slower global growth, the two negative factors most often cited across manufacturing industries, may continue.

Tight labor markets have led to upward pressure on wages. Over the years, reduced union membership and a greater concentration of large firms have shifted wage bargaining power from workers to businesses. Skilled labor shortages have boosted wage gains for key employees, but firms have also used non-wage incentives to attract and retain workers, including signing bonuses and offering more vacation and other perks. Cost containment remains a key theme for corporate America.

## HEADWINDS ON THE HORIZON

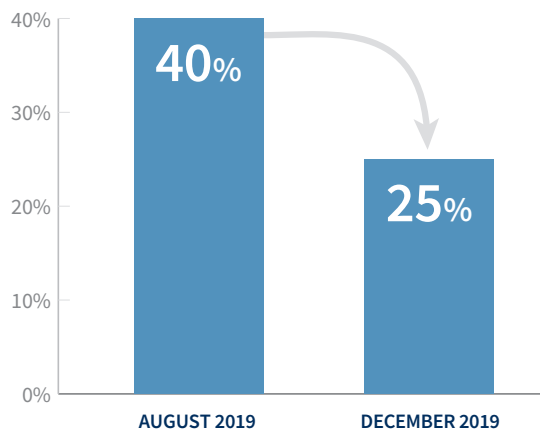
Business fixed investment weakened in 2019. Corporate tax cuts failed to deliver as advertised, and economists were surprised by the degree of the shortfall in business investment. A decrease in energy exploration and problems at Boeing restrained capital spending in 2019 and the halt in the production of the 737 Max will be a drag in the first half of 2020. Trade policy uncertainty and slower global growth, the two negative factors most widely cited

“Trade policy uncertainty and slow global growth, the two negative factors most often cited across manufacturing industries, may continue.”

across manufacturing industries, may continue to some extent. In contrast to consumer confidence, which has remained elevated, business sentiment weakened in 2019.

While a full trade agreement that rolls back tariffs appears unlikely, there is hope for a truce in trade tensions between the US and China (i.e., an agreement not to escalate). However, there is a danger of a further separation of the world’s two largest economies, and protectionist sentiments have risen around the world. Tariffs raise costs for US consumers and businesses, invite retaliation, disrupt supply chains, and undermine business investment. Moreover, the administration has weakened the World Trade Organization, the arbiter of global trade disputes. Ahead of the 2020 election, there ought to be incentive for President Trump to put trade issues behind him. However, bashing China (and others) on trade plays to his base, and some of the Democratic contenders have adopted similar anti-China rhetoric.

### Recession Odds Over the Next 12 Months



### RECESSION ODDS: FROM RISING TO RETREATING

A simple yield curve model of recession suggests about a 25% chance of a downturn within the next 12 months, down from 40% in August, but still a little too high for comfort. The main risk is that the factors that have restrained capital spending will worsen, leading to reduced hiring and increased layoffs, but there are currently few signs of a deterioration in labor market conditions. Consumer debt appears manageable, but business debt has risen significantly (especially for those with greater credit risk, which could make a downturn worse). Investors should focus on corporate layoff intentions and job offerings, two early indicators of labor market conditions.

It is a presidential election year, so political uncertainty will be a factor in 2020. The Democratic platform is expected to center on universal healthcare, climate change, income inequality, tax policy, and antitrust/monopoly regulation – any of which would have repercussions for certain corners of the financial markets. Over the course of the year, investors may begin to fear change in Washington, but it is unlikely that the Democrats will gain a 60-seat super-majority in the Senate, making it extremely difficult to raise taxes or to shift the regulatory environment significantly.

### EMERGING EXPECTATIONS

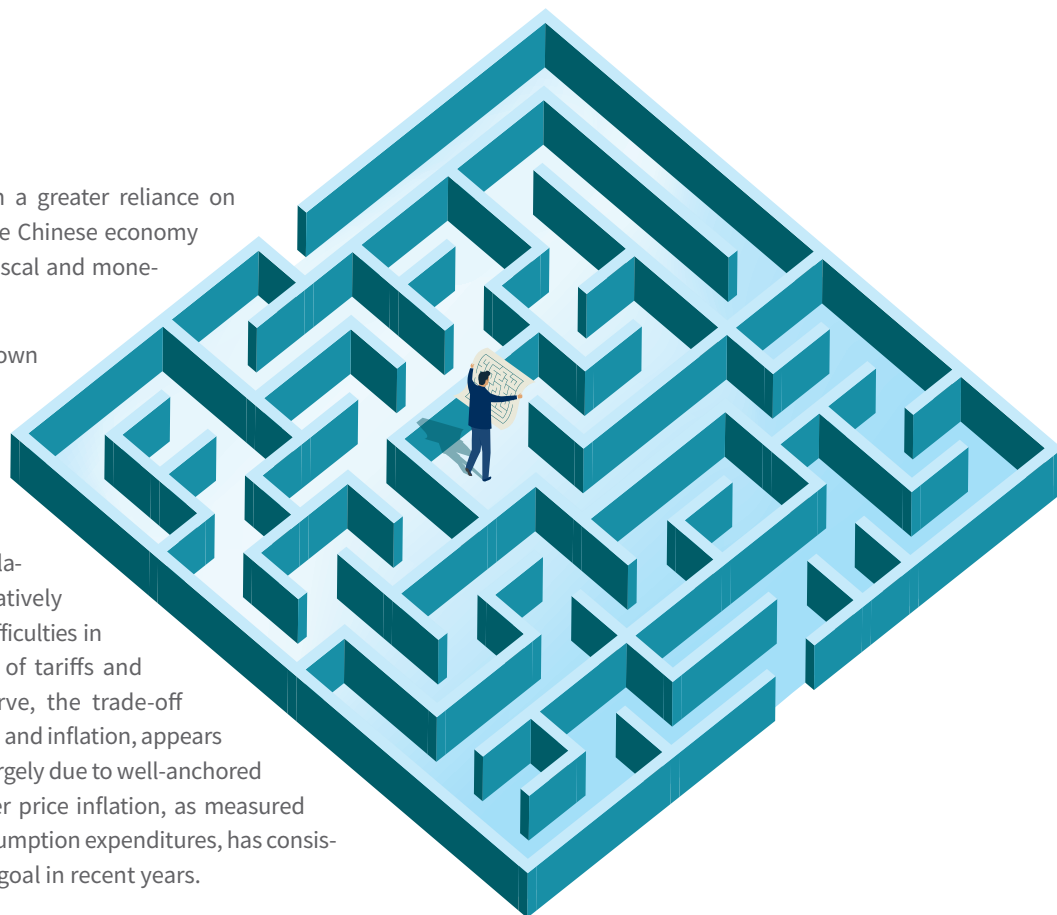
Outside of the US, the advanced economies face the demographic challenges of aging populations and slower growth in workforces. Disruptions from Brexit are a risk. Emerging economies were weaker than anticipated in 2019, but are likely to pick up in 2020. These countries face the same demographic challenges as the advanced economies. However, many have made significant strides in education and have more room for improvement in living standards. Over the last decade, emerging economies have become increasingly sensitive to US Federal Reserve policy. The Fed’s 2019 rate cuts will help. China’s current problems go far beyond trade policy issues; growth has been fueled more by debt

## Data-Dependent Diagnosis

The Fed holds that its monetary policy is well positioned to support economic growth, a strong labor market, and near-2% inflation in 2020. However, the Fed remains ready to deploy further monetary support should economic data deteriorate further.

in recent years, there has been a greater reliance on state-owned enterprises, and the Chinese economy appears to be less sensitive to fiscal and monetary policy stimulus.

US bond yields have been held down by low long-term interest rates abroad. Some increase in US bond yields is likely in 2020, reflecting somewhat higher bond yields outside the US, but probably not much given that inflation is expected to remain relatively low. Firms have generally had difficulties in passing along the added costs of tariffs and higher wages. The Phillips Curve, the trade-off between the unemployment rate and inflation, appears to have flattened significantly, largely due to well-anchored inflation expectations. Consumer price inflation, as measured by the deflator for personal consumption expenditures, has consistently been below the Fed's 2% goal in recent years.



### FED POLICY WELL POSITIONED

The Fed raised short-term interest rates in 2018 as part of its policy normalization. In December 2018, officials thought that monetary policy was still accommodative and most expected one or two further rate increases in the year ahead. Instead, the Fed lowered the federal funds target rate range three times in 2019 (to 1.50-1.75%) as it reacted to increased downside risks from trade policy uncertainty and slower global growth. These cuts were viewed largely as insurance against downside risks in 2020. Fed officials believe that monetary policy is currently well positioned to support economic growth, a strong labor market, and near-2% inflation in 2020. No change in rates is anticipated through the first half of the year, but the Fed will respond if conditions warrant

(that is, if we see deterioration in the labor market). The Fed values its independence and its policy decisions will not be influenced by political pressure.

The Fed was unwinding its balance sheet at the start of 2019, but expected to end that in October. In February, the Fed shifted its balance sheet policy framework from a specified size goal to one of maintaining an adequate level of reserves in the banking system, and anticipated that the balance sheet would eventually expand in line with that goal. The Fed ended the unwinding of the balance sheet in July, three months early. In September, a squeeze developed in the repo market. The Fed stated that this



“In contrast to consumer confidence, which has remained elevated, business sentiment weakened in 2019.”

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was a technical issue, but the central bank seemed caught off guard and followed up with efforts to insure liquidity in the money markets into early 2020.

In 2019, the Fed made a comprehensive review of its monetary policy strategies, tools, and communication practices. This review included academic conferences and town hall meetings. Some changes may be announced in 2020, but probably nothing major. One possibility would be a ‘catch-up’ policy, where inflation would be allowed to move above the 2% target for some specified period if it had fallen below 2%. However, comments from officials make this doubtful. The Fed has also been reviewing its strategies for fighting a recession. The Fed normally lowers the federal funds target rate by 500 basis points during a recession. Given the proximity to the effective lower bound (0-0.25%), the central bank should be more aggressive in lowering short-term interest rates, moving sooner and making larger cuts than it would otherwise. Officials have ruled out negative interest rates, but would rely on forward guidance and further asset purchases if warranted.

In town hall meetings, Fed Chair Powell was particularly impressed with the comments of those from low-income communities. These communities had been largely bypassed during the economic recovery, but were now seeing increased opportunities and the benefits of a tight labor market. With inflation below the Fed’s 2% goal, monetary policy is expected to remain accommodative for an extended period. ■

**KEY TAKEAWAYS:**

- Many of the 2019 uncertainties seem likely to continue into the first half of the year, but the downside risks to the growth outlook appear to be less worrisome.
- Trade policy uncertainty and slower global growth, the two negative factors most widely cited across manufacturing industries, may continue to some extent. In contrast to consumer confidence, which has remained elevated, business sentiment weakened in 2019.
- Fed policy is expected to remain on hold until we get a material change in economic conditions.



# 2020 International Outlook: The Prospects of Positive Progress

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

A recent asset allocation study suggested that, over the last ten years, a portfolio with maximized risk-adjusted returns would have been fully allocated to US equities.\*\*

Since the end of the global financial crisis, the US market has indeed been the standout. Other markets around the world remain its poorer cousins. Yet, as we enter a new decade, it is high time to reevaluate US-centric positioning.

Lower earnings multiples, higher dividend yields, and an overvalued US dollar are, on their own, insufficient reasons to invest abroad. The catalysts that will cause international markets to roar back to recovery will be found in bona fide developments. With that said, can we be truly positive about the prospects in Europe, Asia, and elsewhere around the world for the upcoming year? Certainly, the global trade tone will be heavily influential (especially with most international economies more open and, hence, dependent on trade than the US). While any trade angst is unlikely to be a helpful backdrop either in the US or abroad, the prospects of positive progress remain encouraging.

Outside of trade matters, what else can we discern? Let us start our global tour on the other side of the pond.

As we enter a new decade, it is high time to reevaluate US-centric positioning.

## DOWN, BUT NOT OUT

At the time of this writing, the UK still remains a member of the European Union. However, it is reasonable to assume that this will not be the case for much longer, following the result of the mid-December general election. As is the nature of modern-day trade deals, this simply marks the end of the beginning for the Brexit debate. Many additional months of negotiation will be required to finalize the regulations and rules associated with the divorce. Many UK assets (including the pound) have been under increased pressure due to Brexit uncertainty and Parliamentary logjams. Should these fears dissipate, it is reasonable to believe that there remains room for UK assets to rebound in 2020 as economic activity recovers. However, much will rest on those very specific ongoing discussions. The devil has always been in the details with Brexit - and this remains very much the case.

Change is in the air in the euro zone too. Not only have new appointments been made to the top of the European Commis-

sion (EC) and European Central Bank (ECB), but the dwindling of German Chancellor Angela Merkel's political clout has created a vacuum (which has only been partially filled by President Macron of France). Whilst political crisis often appears only a short step away in the euro zone, the message that members are stronger together has seemingly stayed the hand of populist political parties. Expect new ECB President Christine Lagarde to lobby regional governments more successfully than her predecessor for greater use of fiscal policy levers. However, as Japan has demonstrated, such actions are not a standalone solution. The euro zone still needs to decisively, and dynamically, enter the competitive global economy of the 21st century. 2020 is likely to be another transitional year, and, fortunately, expectations are low (as shown by the preponderance of negative-yielding government bonds and recent quantitative easing policy extension).

Similar policy conclusions could be made about Japan, albeit their policy malaise has been ongoing for over a quarter of a century now. Expect a small boost from the country hosting the Olympic games this summer. However, it will take more than the world's most famous sporting gathering to shift the Japanese economy out of dullness dominated by debt and demographics. Yet, below the surface, Japanese companies are becoming more shareholder friendly (similar to some recent trends in their European peers), with both return on equity and buyback statistics up sharply. Again, an unappreciated market with some

value characteristics may provide some attractions for suitably specific global investors.

### TO IMPROVE IS TO CHANGE...

Elsewhere in Asia, it is all a question of managing change. The Chinese economy will continue to grow impressively from an international perspective, as the prowess of the local consumer continues to build. However, policymakers are increasingly having to manage new pressures across areas such as the local government, the banking system, and the property market. These are undoubtedly the unsurprising outputs from change and reform, which continue at a magnitude which puts other countries and regions to shame. However, greater global focus on political-led pressures in Hong Kong and Xinjiang are also likely to continue rumbling on.

Diplomatically, this is a crucial time for China. Its Belt and Road initiative was launched with great fanfare, but has not yet had the impact that Beijing had hoped. Watch out for the potential that China further deepens its ties with Europe in 2020, a synergy which would provide both sides with a boost.

Elsewhere, markets in South America and Africa will hope for a firm Chinese economy given their important trade relationships. Reform initiatives in countries such as Brazil as well as a number of East African nations bode well. Although, the back-

## Caught in the Vortex

The trade war between the US and China has caused collateral damage abroad, with many developed economies caught in the crossfire. However, recent positive progress remains encouraging.





## Brexit - The Final Countdown



“The Chinese economy will continue to grow impressively from an international perspective, as the prowess of the local consumer continues to build. However, policymakers are increasingly having to manage new pressures.”

drop is far from flawless (as the recent fall in value of the Brazilian currency has shown). Both zones also have their fair share of troubled nations, struggling with debt and citizen discontent. Meanwhile, firmer commodity prices would aid Russia, the Middle East, and Australia, an outcome relatively dependent on bigger discussions about global trade and the speed of the opening of the Chinese economy.

### ... TO PERFECT THE PORTFOLIO

Aside from the fallout from trade wars, there remains burgeoning pressure for countries around the world to forge new diplomatic allegiances and strengthen trade ties. Both could be boons for investors. Yet, methodical and disciplined asset selection remains paramount. Actively-managed strategies and sufficient diversification are certainly warranted when investing abroad. Though an exclusive allocation to US assets has been rewarding over the past decade, international assets may yet provide untapped potential in the next decade ahead. ■

### KEY TAKEAWAYS:

- Lower earnings multiples, higher dividend yields, and an overvalued US dollar are, on their own, insufficient reasons to invest abroad. The catalysts that will cause international markets to roar back to recovery will be found in bona fide developments.
- While any trade angst is unlikely to be a helpful backdrop either in the US or abroad, the prospects of positive progress remain encouraging.
- The Chinese economy will continue to grow impressively from an international perspective, as the prowess of the local consumer continues to build. However, policymakers are increasingly having to manage new pressures.
- Aside from the fallout from trade wars, there remains burgeoning pressure for countries around the world to forge new diplomatic allegiances and strengthen trade ties.

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# 2020 Equity Outlook: Encouraging Environment for the Stock Market

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

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

In 2020, we expect the trade war to simmer, the slump in US and global manufacturing to improve, the global macro to benefit from central bank policy actions over the past year or so, while corporate profits will re-accelerate to the upside. All of the above paint a positive picture for the US and global equities. Despite our positive bias, we warn the path to equity gains will not be without typical periods of volatility, with global manufacturing stabilizing (as opposed to recovering) at this writing. Also, setbacks with trade remain a possibility with adherence to final terms of the 'Phase One' trade deal necessary. After the nearly 30% gain for US stocks in 2019, valuation leaves little room for multiple expansion, with the price to earnings (P/E) multiple over 19x trailing 12-month earnings. For this reason, the resumption of earnings growth is paramount to our theme.

We produce a year-end target of 3,350 for the S&P 500 by combining a forecast of 5.5% earnings growth and a flat P/E multiple of 19.25. The modest 6.7% total return (dividend of 1.9%) high-

Ebbing trade tensions and the effects of central bank easing should begin to stimulate global economic conditions in 2020.

lights the importance of buying the pullbacks as they develop throughout the year to maximize gains.

From an execution standpoint, we currently favor US large caps, but this could shift rapidly. We are closely monitoring US small caps due to our expectations that manufacturing will recover and that earnings growth will resume. In recent years, manufacturing cycles and US small-cap relative performance have been tightly correlated. For now, we are waiting for additional evidence of manufacturing improvement and a breakout of relative price momentum for the small caps before increasing allocations.

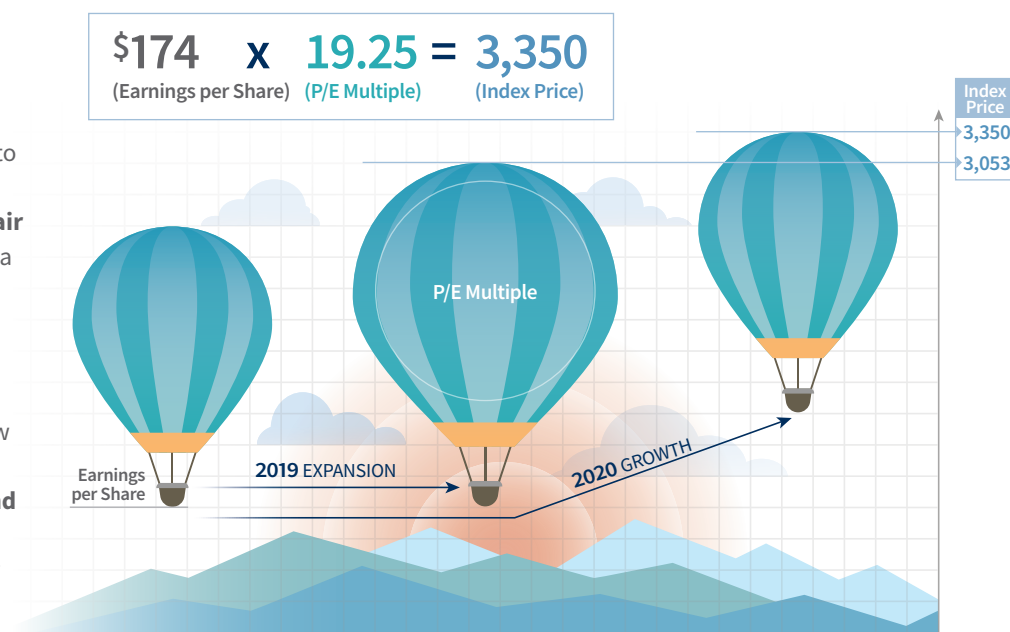
Globally, emerging and developed (ex-US) markets are possibly positioned more favorably than in recent years. Easing by many central banks around the world, an expected improvement in global trade and manufacturing (due to the simmering trade war), and a slightly weaker US dollar are all catalysts for relative outperformance versus the US. But like with small caps, we would

## The Price to Earnings (P/E) Multiple Explained

When determining the price of an equity index (e.g., the S&P 500 Index), two variables are taken into account: earnings and the price to earnings (P/E) multiple. When earnings are multiplied by the P/E multiple, the product is the price of the index.

**2019** The price of the S&P 500 increased even though earnings remained relatively flat. This was due to an expansion of the P/E multiple. **One can think of the P/E multiple as the air in a hot air balloon** - it can expand to a larger size and bring the top of the balloon to a higher level, even though the basket remains in the same place.

**2020** Earnings are expected to grow at a higher rate than they had in 2019. **One can think of earnings as the wind that lifts a hot air balloon** - when it rises, so too does the top of the hot air balloon, bringing it to a higher level.



**In both cases, one can think of the top of the hot air balloon as the index price.**

**In 2019,** the top of the balloon rose because the hot air (P/E multiple) expanded.

**In 2020,** we expect the top of the balloon to rise because earnings will grow.

take a pragmatic approach and wait for additional evidence to develop in all these areas before increasing global allocations.

At the US sector level, we favor cyclical over defensive given the favorable backdrop for US equities. Should it develop, the recovery in manufacturing could influence a slight uptick in longer interest rates, which will hold back the relative performance of many of the interest-sensitive defensive sectors.

### TRADE SIMMERS IN 2020

The 2020 election helps influence our belief the trade war will ‘simmer’ in 2020. Since World War II, only three incumbents (Ford ’76, Carter ’80, and Bush Sr. ’92) lost reelection. In all three cases the economy was either weakening or contracted during their term in office. With a strong jobs market, a solid consumer, a Federal Reserve (Fed) on hold (after cutting rates three times in the second half of 2019), and manufacturing showing signs of recovery, trade tensions and tariffs are the primary wild card/

potential headwind to the economy in 2020. We believe that President Trump knows this, and will do enough to support the economy and markets into his reelection campaign next year, ‘kicking the can down the road’ with respect to the more difficult, structural issues between the US and China.

### MANUFACTURING IN THE MIX

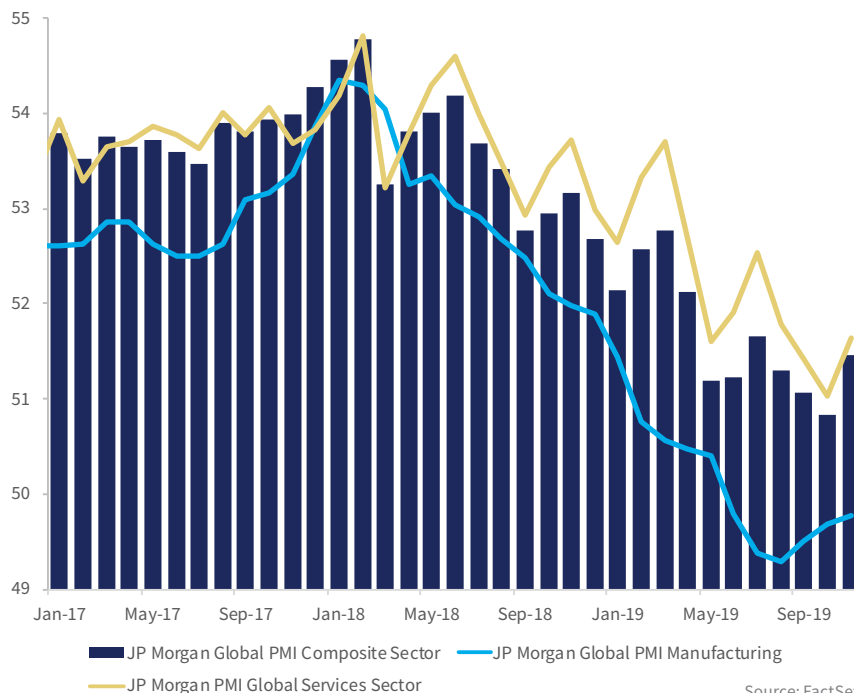
A major theme influencing our stance toward the market and positioning is our belief that manufacturing trends will likely turn higher. Ebbing trade tensions and the effects of central bank easing should begin to stimulate global economic conditions in 2020. The ‘hard data’ has not yet turned, but some leading indicators (such as manufacturing surveys) have begun to show signs of a potential recovery. For the better part of two years, manufacturing trends have deteriorated in the face of trade tensions. So, if these pressures begin to improve, it should provide a more supportive global economic environment for equities.



## Mustering Manufacturing Muscle

Global manufacturing shows signs of rebounding, a development that bodes well for the global economy and equity outlook.

“If these pressures begin to improve, it should provide a more supportive global economic environment for equities.”



Source: FactSet

### EXPANDING EARNINGS

S&P 500 earnings are also expected to improve in 2020. Given how rapidly earnings grew in 2018 following tax reform, the bar was set high for growth in 2019. Even so, earnings for the S&P 500 managed to grow at 1.3% in 2019. Yet, while this number reflects the earnings for the entire index, it conceals a relatively robust 5.5% earnings growth for the average company within the index (i.e., on an equal-weighted, rather than market cap-weighted basis). In 2020, we forecast S&P 500 earnings will grow 5.5% to \$174 per share. Our base case year end S&P 500 price target of 3,350 results by applying a P/E multiple of 19.25 to our forecasted earnings.

### BULL, BASE, AND BEAR

We believe that there is a 70% chance that our ‘base’ case estimate (3,350) for the S&P 500 comes to fruition. This hinges on the circumstances we have outlined above.

In the event that trade negotiations improve significantly, economic conditions expand above expectations, earnings surprise to the upside, sentiment improves, inflation and interest rates remain low, and the Fed remains on hold, our ‘bull’ case for the S&P 500 is 3,628. This is based upon earnings per share of \$177 and a P/E multiple of 20.50. We believe that there is a 20% chance that this case comes to fruition.

On the other hand, if President Trump ‘digs in’ on trade, sentiment deteriorates, economic conditions disappoint, but a dovish Fed becomes more accommodative, our ‘bear’ case for the S&P 500 is 2,640. This is based upon the application of 30% tariffs on all trade between the US and China (a long way off at this point), earnings per share of \$165 (i.e., flat growth), and a P/E multiple of 16.00. We believe that there is a 10% chance that this case comes to fruition.

### SECTOR SELECTION

At the sector level, our view supports a pro-cyclical stance to allocations. We remain overweight the Technology, Communication Services, and Health Care sectors; recently, we upgraded the Financials and Industrials sectors to overweight recommendations as well. Fundamental and technical trends for the Technology, Communication Services, Financial, and Health Care sectors remain favorable in our opinion.

The relative performance of the Industrials sector has been correlated with manufacturing new orders over the past ten years. Obviously, weak manufacturing has weighed on the sector for the past two years. In the process, this has brought valuations to more attractive levels. Given that we believe manufacturing pressures should abate and show improvement in 2020, we recommend an overweight allocation to the Industrials sector.

## Raymond James Equity Portfolio & Technical Strategy 2020 Year-End Outlook

We do not believe interest rates will move appreciably higher given the persistence of slow growth, low inflation, and low global bond yields. However, we believe that interest rates and the yield curve will stabilize (and could tick higher), both of which bode well for the Financial sector. Along with attractive valuations, we believe this supports an overweight allocation to Financials.



	S&P 500	EPS ESTIMATE	P/E	PRICE	SCENARIO ODDS
<b>Bull Case</b>		\$177	20.5x	3,628	20%
<b>Base Case</b>		\$174	19.25x	3,350	70%
<b>Bear Case</b>		\$165	16x	2,640	10%

Source: Raymond James Equity Portfolio & Technical Strategy

A risk to our allocations is that we could be early in timing the manufacturing rebound. Thus, we would buy partial positions as the rebound proves to be increasingly sustainable. We have equal weight recommendations on the Consumer Discretionary and Energy sectors, while we have underweight recommendations for Consumer Staples, Utilities, Real Estate, and Materials.

inverse correlation with the US dollar; given that we believe the dollar has a downward bias, this also bodes well for emerging markets. Additionally, we view the valuation and earnings growth outlook as attractive. Tactically, our current bias is more favorable toward emerging markets vs. developed ex-US, resulting in an equal weight to slight overweight until additional evidence or recovery develops. ■

### OTHER OPPORTUNITIES

We give a slight overweight to the small caps (vs. large caps) in 2020, as they ‘catch up’ from underperformance since the fall of 2018. Valuation is not cheap, but earnings are set to accelerate. Moreover, small-cap relative performance has been 86% correlated with US manufacturing over the past three years (which we expect to improve).

Finally, our view of easing trade tensions and improved global manufacturing trends in 2020, along with global central bank stimulus flowing through the system, should support an improved global equity market environment. We continue to favor the US over developed markets for now. If European manufacturing improves to a greater degree than US manufacturing, European equities are likely to outperform as valuation is attractive in various areas of Europe. However, for now we stay tactically overweight the US until those trends change.

Emerging markets should reap outsized benefits during a global manufacturing recovery. The index also exhibits a significant

### KEY TAKEAWAYS:

- In 2020, we forecast S&P 500 earnings will grow to \$174 per share. By applying a P/E multiple of 19.25, our base case is that the S&P 500 will rise to 3,350 by the end of 2020, approximately 6% above current levels.
- At the sector level, our view supports a pro-cyclical stance to allocations. We are overweight the Technology, Communication Services, Health Care, Industrial, and Financial sectors.
- We maintain our generally positive stance to trade talks, but acknowledge that setbacks and volatility are likely to continue along the way.
- Low inflation, accommodative monetary policy, rebounding manufacturing, and a steepening yield curve are further supportive of equities.

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## 2020 Fixed Income Outlook

**Doug Drabik**, *Managing Director, Fixed Income Research*  
**Kevin Giddis**, *Chief Fixed Income Strategist, Investment Strategy*  
**Nick Goetze**, *Managing Director, Fixed Income Services*

The fixed income market surprised many in 2019 by rallying for much of the year. In 2018, most believed the Federal Reserve (Fed) would continue to tighten monetary policy by raising its benchmark interest rate. Many valuations anticipated that the 10-year Treasury would settle close to 3.00%. In our outlook last year, we cautioned that certain geopolitical factors could weigh heavily on the fixed income market, pulling interest rates significantly lower than anticipated. Brexit instability and the US/China trade war were chief amongst these factors, heavily influencing the interest rate environment. For our 2020 forecast, we believe the yield on the 10-year Treasury will be 1.75% at year end.

The Fed reversed its approach, turning from tightening in 2018 to easing in 2019. The Fed cut its benchmark interest rate by 25 basis points (i.e., 0.25%) three times in 2019. This brought short-term interest rates down relative to long-term rates, thus returning the yield curve to a positive slope. The spread between the 10-year and 3-month Treasury yields had previously been inverted for more than four months. The US continues to boast

While the market has been influenced significantly by the US/China trade talks, the most influential factors for fixed income remain accommodative monetary policy and the lack of inflation.

high employment, low inflation, moderate growth, and favorable rates relatively to nearly all developed markets.

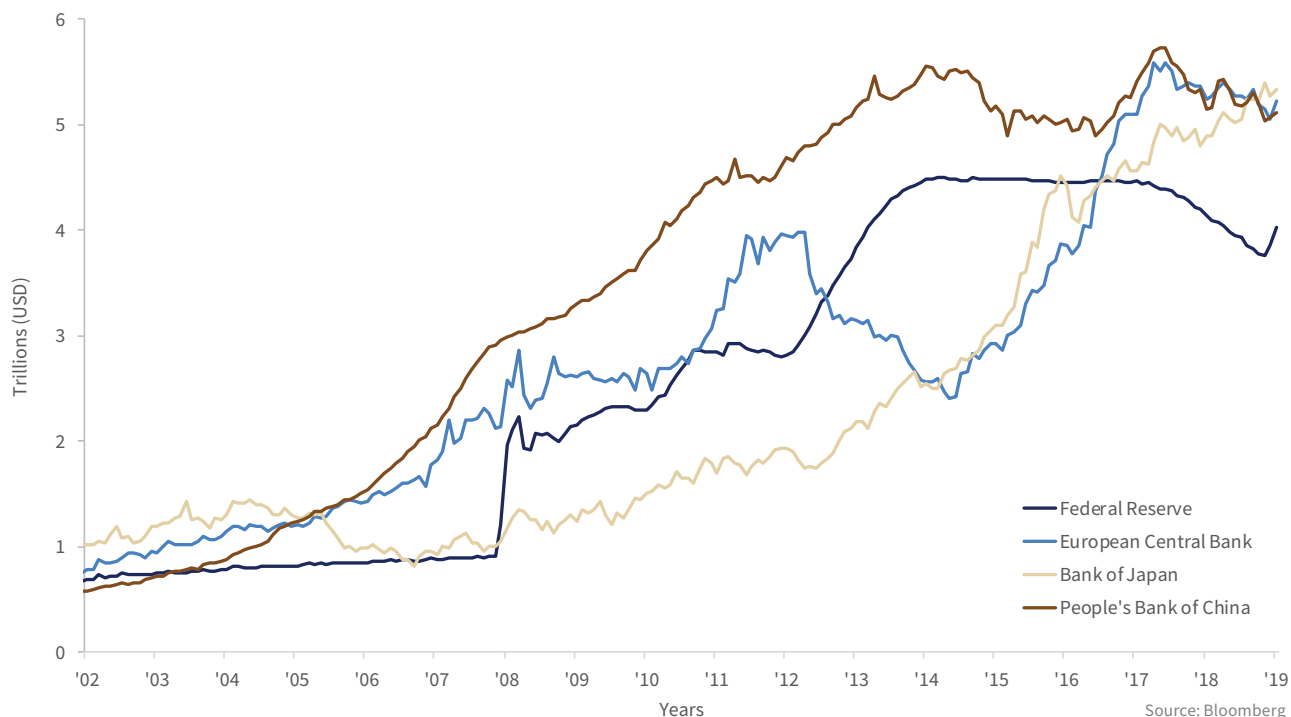
### FOCUSING ON FACTORS

While the market has been influenced significantly by the US/China trade talks, the most impactful factors for fixed income remain accommodative monetary policy and the lack of inflation. Continual quantitative easing (QE) has ultimately contributed to higher bond/stock prices and tightening of credit spreads.

Interest rates will continue to face significant headwinds in 2020, keeping them from moving higher. Low interest rates abroad will keep demand for US bonds high. Furthermore, an aging, retiring population in the US will keep demand high for income-producing assets (i.e., bonds) as well. Barring high inflation, accommodative central bank policy will prevent rates from moving significantly higher. The combination of high demand and low rates will likely



## Central Bank Balance Sheets - Total Assets



increase the appetite for risk, leading to credit tightening in lower investment-grade and high-yield credits. Furthermore, a significant increase in interest rates is doubtful given that high government debt provides additional incentive to keep rates low.

Several market factors or events could trigger a much greater than anticipated rate decline including: global deflation, lower earnings/corporate decline, escalating central bank purchases, and/or political disarray. Though most coverage will focus on the presidential race, the composition of Congress to one-party dominance would likely tilt investor response. Should any of these events overstate anticipation, market volatility could intensify and by example, the 10-year Treasury could decline to a 1.25%-1.50% range (lower than the 1.75% prediction).

### ADJUSTING ALLOCATIONS

Appropriate asset allocation is an integral discipline under current market conditions. Escalating volatility and the historically longest business cycle on record (126 months of economic expansion) should heighten investor awareness. For many investors, fixed income assets mitigate risk by providing consistent cash flows, predictable income, and principal preservation. They serve to balance the higher risk associated with growth assets. The two portfolio subsets, equities and fixed income, are compatible, not substitutable. Certain fixed income attributes champion the standards of

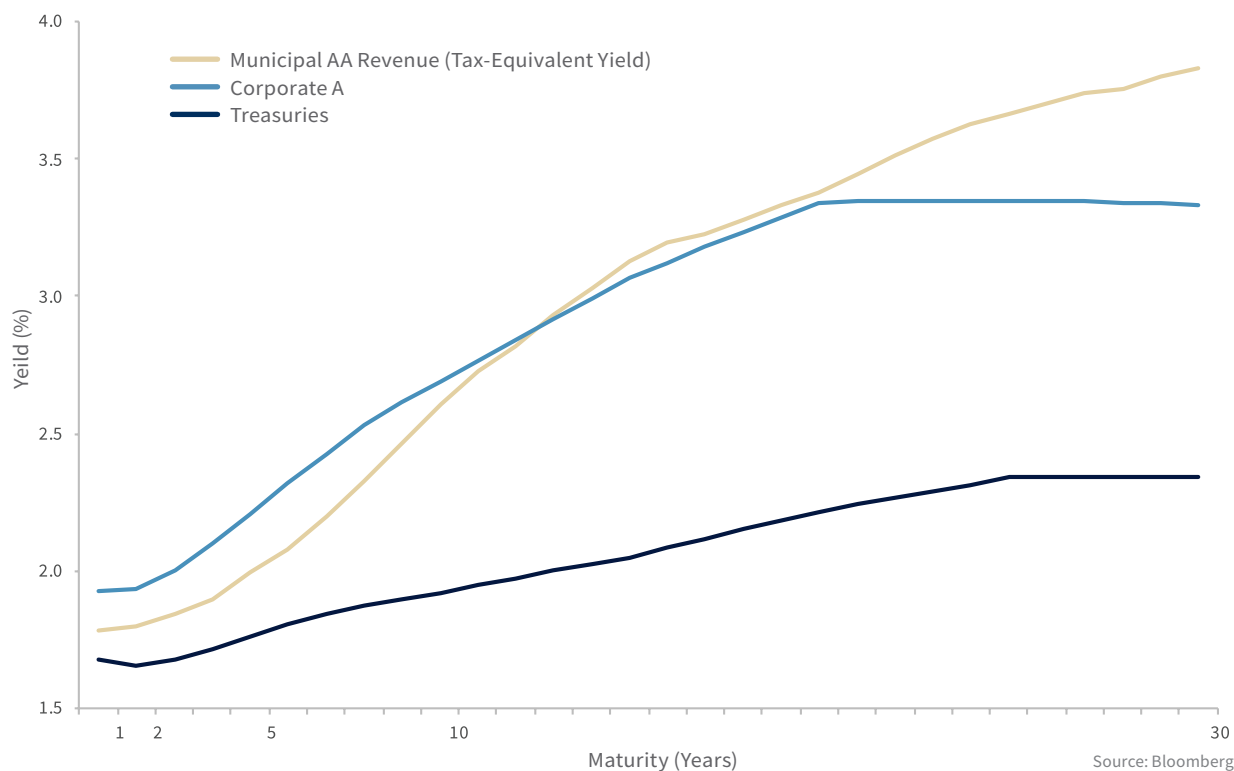
defense required for the forthcoming end of the business cycle: fixed maturities, locked-in cash flows and predictable income.

“ Appropriate asset allocation is an integral discipline under current market conditions. ”

Although there is an inherent focus on the Treasury market, mainstream investors often invest in other fixed income assets, such as corporate and municipal bonds. The aforementioned circumstances have caused the Treasury yield curve to flatten relative to the corporate and municipal yield curves (both of which have retained a positive slope and a spread over Treasuries). A positively sloped curve rewards investors who assume duration risk (i.e., investing in longer-term bonds).

Amid higher demand for higher yields, pricing has remained steady amongst emerging market (EM) debt. Specifically, dollar-denominated sovereign and corporate bonds boasted a strong

## Yield Curve Comparisons



2019. Corporate EM debt is over \$2.0 trillion, with over half rated at investment grade. Sovereign debt has been rebounding in tandem with economic growth. While Asia delivered much of the GDP growth last year, Latin America posted steady economic growth as well. EM bond prices, much like domestic bond prices, have been supported by low global inflation.

### MIND THE CORRELATION

High-quality individual bonds with intermediate or long durations offer negative correlation to many growth assets (such as equities). Given that bonds balance growth assets, this asset-allocation blend provides portfolios more stability with respect to anticipated returns. Very short-duration bonds do not have the negative correlation that long-duration bonds have; therefore, they generally do not provide a counterbalance to equities. Ultra short-duration bonds provide stability and near-term liquidity for investors, while intermediate- and long-duration bonds provide higher yields and income further out along the yield curve. ■

### KEY TAKEAWAYS:

- While the market has been influenced significantly by the US/China trade talks, the most impactful factors for fixed income remain accommodative monetary policy and the lack of inflation.
- Interest rates will continue to face significant headwinds in 2020. Low interest rates abroad will keep demand for US bonds high.
- Fixed income assets mitigate risk by providing consistent cash flows, predictable income, and principal preservation. Fixed maturities, locked-in cash flows, and income all bode well when investing in a late business cycle environment.

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# 2020 Energy Outlook

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

After fixating on demand throughout 2019, the oil market is likely to start trading on bullish supply dynamics in 2020.

For most of 2019, oil prices traded rather aimlessly, averaging approximately \$57/Bbl (WTI) and \$64/Bbl (Brent), well below their averages in 2018. While basic economic theory suggests that commodities trade on both supply and demand, demand seemed to drive oil price movements last year.

Amid two major sources of macroeconomic uncertainty (i.e., the US/China trade war and the Brexit process) headlines pertaining to global oil demand played a dominant role in influencing prices. Consequently, the market essentially ignored the supply side of the equation, which augured a much more bullish outcome. Ultimately, oil prices were largely dictated by demand.

## 2020: FUNDAMENTALS WILL PREVAIL

With 2019 in the rearview mirror, we forecast that oil prices will recover to six-year highs by the end of 2020. Fundamentals matter; both supply and demand matter in equal measure. Even with the lingering US/China and Brexit headwinds, we anticipate that global oil demand will grow slightly faster in 2020 than this past year, marking 11 consecutive years of growth.

Due to the implementation of IMO 2020 low-sulfur fuel regulations, demand for diesel is likely to be particularly robust. More importantly, there is an unusually bullish combination of supply-side factors.

With 2019 in the rearview mirror, we forecast that oil prices will recover to six-year highs by the end of 2020.

Saudi Arabia is showing a degree of production discipline that has been a historical rarity. This was true before the recent initial public offering (IPO) of Saudi Aramco, the state-owned oil company. Cynics would say it was an effort to smooth the IPO process; by this logic, Saudi Arabia will presumably want to continue propping up Aramco's stock price by supporting oil prices. The persistent issues curtailing supply from Iran (US secondary sanctions), Venezuela (internal economic collapse), and Nigeria (local militancy) seem likely to continue for the foreseeable future. Meanwhile, as backwardated (downward-sloping) oil futures exert pressure on the capital budgets of US oil and gas companies, and thus shale drilling activity slows, domestic production growth is set to slow sharply in 2020.

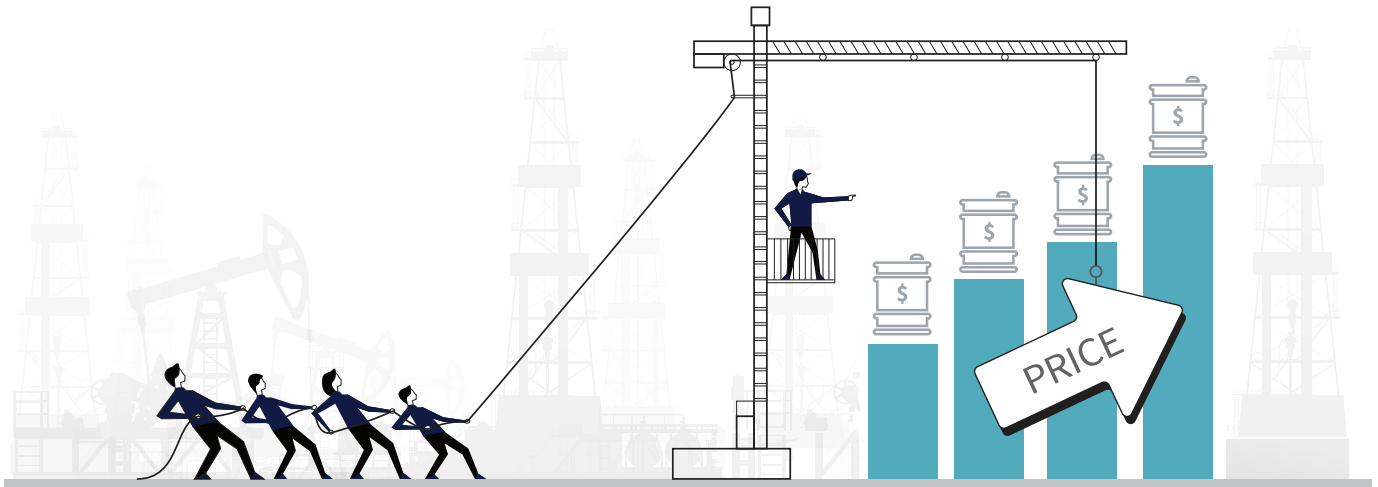
## WILDCARDS FOR OIL

Whenever making forecasts about the global oil market, it is important to discuss potential wildcards. Barring a severe global recession, demand is unlikely to present much uncertainty, whereas supply is more of a proverbial 'black box.' In the wake of this past September's stunning drone attack against Saudi energy infrastructure, which caused the world's largest oil



## Propping up Prices and Production

OPEC and Saudi Arabia have continued to cut their oil production in a bid to prop up global oil prices. This comes amid the initial public offering of Saudi Arabia’s state-owned oil company, Saudi Aramco.






supply disruption since 1991, there remains potential for future instability. Even though we are not assuming additional attacks in our baseline forecast, the possibility cannot be ruled out. An even more dramatic scenario - outright war between Saudi Arabia and Iran, with or without US involvement - looks unlikely based on current geopolitical dynamics (but not impossible). Regime change in Venezuela and escalation of fighting in Libya are other issues to watch.

“Barring a severe global recession, demand is unlikely to present much uncertainty, whereas supply is more of a proverbial ‘black box’.”

## Outlook on Prices: Looking Ahead

Our 2020 forecast of \$65/Bbl WTI and \$70/Bbl Brent is back-end-weighted, with the bulk of the gains likely to come in the latter half of the year.

2020			
	<b>WTI CRUDE</b>	<b>BRENT CRUDE</b>	<b>NATURAL GAS</b>
	<b>\$65/Bbl</b>	<b>\$70/Bbl</b>	<b>\$2.30/Mcf</b>

Source: Raymond James Equity Research

Closer to home, we will be tracking the presidential campaign and its potential effects upon drilling activity, especially shale. Generally, commodity prices matter much more to the US oil and gas industry than who is in the White House. But with two of the top three Democratic presidential contenders - Sens. Elizabeth Warren and Bernie Sanders - pledging to ban hydraulic fracturing (fracking) on federal lands, a regulatory shift along these lines could have a meaningful impact on the industry in 2021 and beyond.

### NATURAL GAS: SUPPLY ON THE RISE

In contrast to our upbeat view on the global oil market, we are less enthused about North American natural gas due to its ‘inverse’ relationship with oil prices. As recovering oil prices eventually incentivize more oil-focused drilling activity, it will spur an increasing supply of associated gas (whether or not there is



demand). Improving takeaway capacity from the Permian Basin will only exacerbate this, along with increased access to Northeast markets from the Marcellus and Utica Shale formations.

The supply side of the gas equation outweighs the mostly upbeat story on the demand side, led by the ongoing ramp-up of US liquefied natural gas (LNG) exports. Pipeline exports to Mexico are also a growth driver, whereas the power sector is a mixed picture. Retirements of coal-fired power plants are disproportionately being replaced by wind and solar rather than gas.

Meanwhile, the European gas market is also rather weak, with demand near 20-year lows. Wind and solar are capturing market share in the electricity mix to an even greater extent than in the US. Led by China, gas demand in Asia is growing, but not as much as the industry would have hoped.

### ESG INVESTING IMPACTS PRICES

Finally, when thinking about the performance of oil and gas stocks - beyond the commodity fundamentals themselves - it will be increasingly vital to consider the environmental, social, and governance (ESG) dimension. ESG investing represents a major long-term trend for institutional and retail investors alike. It is a striking yet under-appreciated fact that 26% of all US professionally-managed assets - equity and debt combined - are already covered by some kind of ESG criteria. Broadly defined, total ESG assets are near \$12 trillion, triple the amount in 2012.

Within the ESG 'pie', the largest 'slice' pertains to climate change. To state the obvious, this trend is more positive for renewable and other low-carbon energy technologies as compared to oil and gas (to say nothing of coal). However, it is possible for oil and gas companies to make operational changes that will make their stocks more appealing for ESG-centric funds. Only a few ESG funds have a blanket exclusion of all oil and gas stocks. Whether it is deploying solar instead of diesel generators, reducing methane flaring, investing in carbon capture, or improving water conservation, the industry is able to adapt to ESG pressures. ■

#### KEY TAKEAWAYS:

- We anticipate that global oil demand will grow slightly faster in 2020 than this past year.
- We forecast that global petroleum inventories will reach historically-low levels, a recipe for higher prices.
- We forecast that WTI will reach \$65/Bbl and Brent will reach \$70/Bbl in 2020.
- Barring a severe global recession, demand is unlikely to present much uncertainty, whereas supply has many more 'wildcards.'

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# The Case for Sound Asset Allocation

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

Balanced-account portfolios have had their best year-to-date (YTD) return through the first three quarters of the year since 2009 as both equities and fixed income have outperformed their long-term averages. The median balanced portfolio, based on the Callan Total Domestic Balanced database, posted a 14.4% total return so far in 2019 (as of September 30). The average return over the last 25 years for this database is around 8.8%.

## VIGILANT FOR VOLATILITY

Coincident with this positive performance of both stocks and bonds, complacency appears high in financial markets. One measure of such overconfidence is the size of the net short position in futures contracts on the Volatility Index (i.e., VIX), which measures the volatility of the S&P 500 Index. Market participants are betting, at record levels, that volatility will remain subdued when the VIX is already hovering around its one-year low.

However, we believe investors should remain cautious. It is important to actively manage exposure in a year during which there have been high correlations between asset classes that have traditionally been uncorrelated (as these asset classes have the potential to return to historical trend). Dislocations in markets can last longer than many would anticipate, leading to a

While the market has been influenced significantly by the US/China trade talks, the most influential factors for fixed income remain accommodative monetary policy and the lack of inflation.

false sense of security. However, when conditions revert back to the mean, it can be a rude awakening for those investors who did not take proper risk management steps.

It is said that higher-than-normal returns are often ‘borrowed’ from the future. Yet, fixed income asset flows suggest that many investors are particularly susceptible to poor market timing. Historically, bond flows follow performance, which is counter to long-term performance results. We have seen this play out multiple times during the current expansion as the economy has now experienced three downturns during which the yield on the 10-year US Treasury note has touched 1.5%.

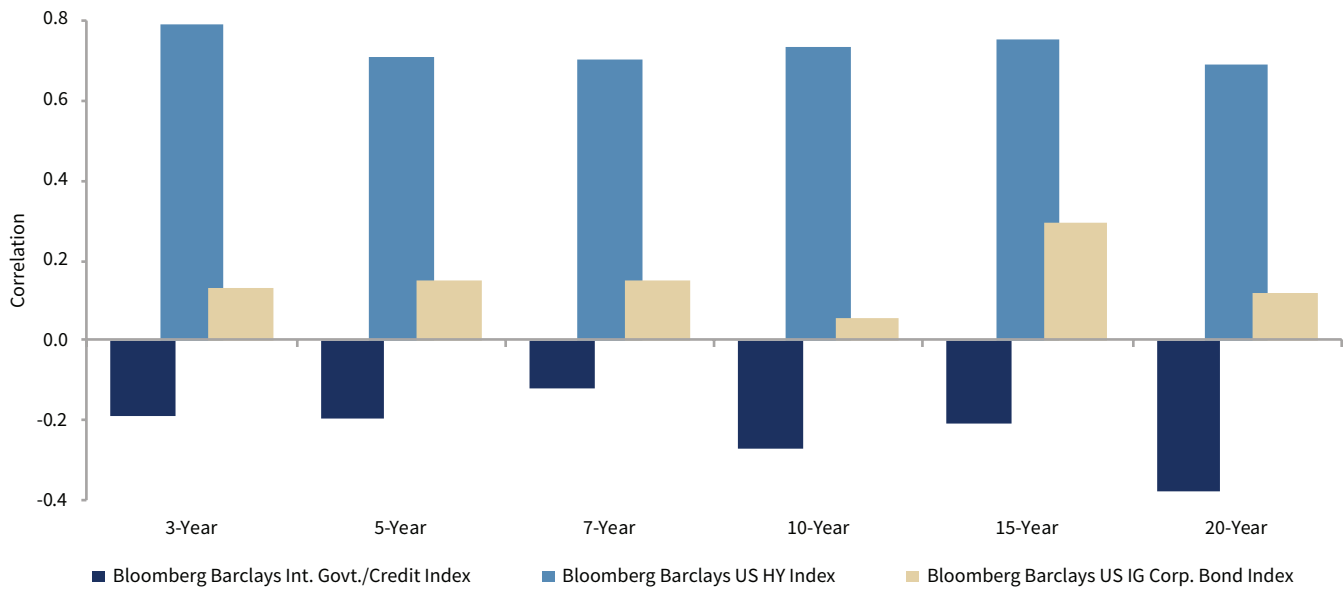
## NOT ALL ASSETS ARE CREATED EQUAL

The traditional 60/40 model was effective in a more ‘normal’ interest rate environment (i.e., when the structure of the bond market was very different from what it is today). We are now in a new age of central bank intervention, rate volatility, and high



## Correlation Relative to the S&P 500 Index

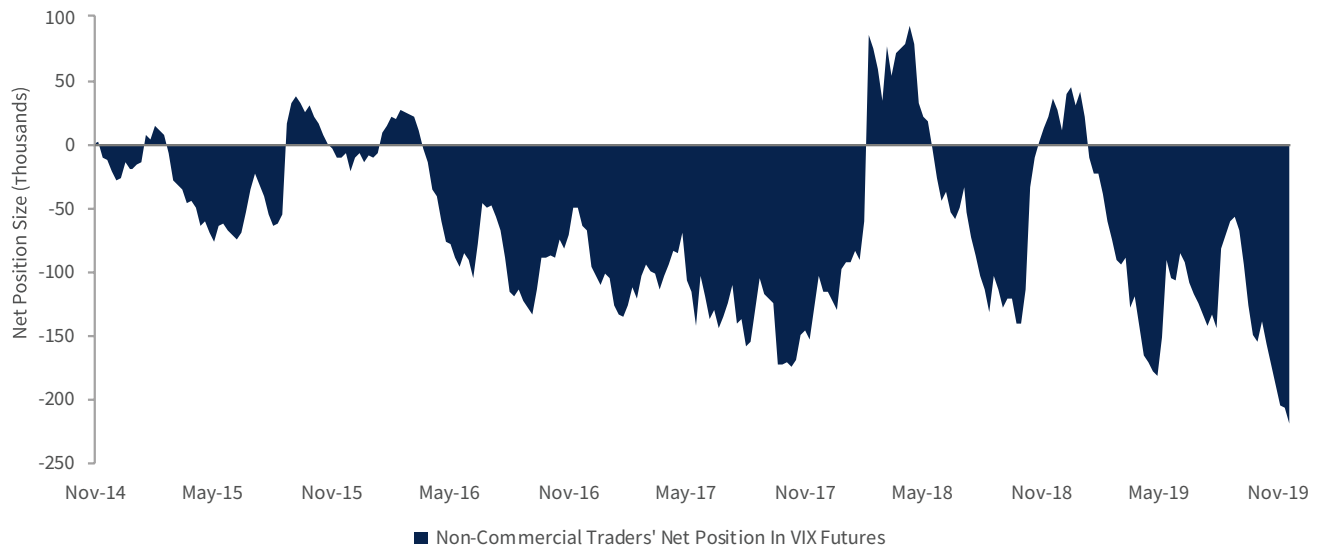
(various time periods ending Sept. 30, 2019)



Source: Bloomberg; monthly and quarterly data as of Sept. 30, 2019.

## VIX Futures at Record Short Levels

(Nov. 2014 – Current)



Source: CFTC, Bloomberg; weekly data as of Nov. 19, 2019.

“We are now in a new age of central bank intervention, rate volatility, and high corporate leverage.”

corporate leverage that must be actively managed on the bond side. Fixed income as a pure yield vehicle at these interest rate levels is challenging. However, the ‘right’ fixed income allocation remains critical to offset to risk assets in the equity portfolio in a balanced-account strategy. That said, not all bonds behave the same during equity market downturns.

An evaluation of the same Callan database based on the fourth quarter of 2018 (when market volatility surged due to the shift in the macroeconomic backdrop) shows a significant variation between the top- and bottom-performing balanced-account portfolios. The median portfolio held up well (-9.0%) relative to the S&P 500 (-13.5%). However, a portfolio that ranked in the tenth percentile performed significantly better (-3.9%), while a portfolio in the ninetieth percentile performed almost as poorly as just owning all stocks (-12.3%).

### RISKY BUSINESS

Again, risk mitigation is one of the biggest advantages in active fixed-income management. One way to ensure gains are insulated is to shorten the duration of fixed-income portfolios. With ultra-short-term US Treasuries now paying nearly the same as longer-term government bonds, active managers can lock in gains, preserve yield, and redeploy (when interest rates move higher and/or corporate-credit spreads widen).

Income investors should also be conscious of the disparity in yields between stocks and bonds given that the yield curve

remains generally flat. Corporations can use borrowed money from the bond market to pay shareholders in the form of higher dividends and share buybacks. Yield is only one factor for any investment, but relative value among asset classes should include yield comparisons.

The key to long-term success and a positive client experience rests in recognizing that it is not just about having a ‘balanced’ portfolio of stocks and bonds. It is about which stocks and bonds are in that portfolio, how they interact with each other, and whether they are managed through a repeatable process that is mindful of asset class labels, or one that potentially exposes investors to undue volatility by conflating the risks of stocks and bonds in the pursuit of unsustainable yields or returns. ■

#### KEY TAKEAWAYS:

- It is important to actively manage exposure in a year when we have seen high correlations between asset classes.
- Dislocations in markets can last longer than many would anticipate leading to a false sense of security.
- It is not just about having a ‘balanced’ portfolio of stocks and bonds. It is about which stocks and bonds are in that portfolio.

## Economic Snapshot

The US economy was mixed in 2019 and is expected to remain mixed in the first half of 2020. Consumer spending growth should remain moderately strong, supported by job gains and wage growth. Business fixed investment has weakened, reflecting a decrease in energy exploration and problems at Boeing. The halt in the production of the 737 Max will subtract from growth. Trade policy uncertainty and slower global growth were also issues in 2019. The trade truce with China reduces (but does not eliminate) uncertainty. Global economic growth is likely to pick up.

**DR. SCOTT BROWN**  
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	EMPLOYMENT	While the amount of labor market slack remains uncertain, constraints are expected to become more binding in 2020 – leading to a slower trend (ex-census hiring). Wage growth has remained strong (but mixed).
	CONSUMER SPENDING	Job gains, wage growth, and consumer confidence remain supportive. Middle class households will face some headwinds from higher health care costs and a lack of affordable housing.
	HOUSING AND CONSTRUCTION	Job growth and wage growth remain very supportive. Mortgage rates have remained moderate. Builders continue to note supply constraints and ongoing affordability issues.
	THE DOLLAR	With Federal Reserve (Fed) policy expected to remain on hold, any pressure is likely to come from changes in the policy of other central banks.
	MONETARY POLICY	The Fed lowered short-term interest rates three times in 2019, leaving monetary policy relatively accommodative. No change is expected, but the Fed would cut rates amid broader signs of economic weakness.
NEUTRAL	GROWTH	Economic activity is expected to be mixed, but generally moderate in 2020. Risks to the growth outlook are weighted to the downside, but appear to be less severe than in the summer of 2019.
	BUSINESS INVESTMENT	Ongoing problems at Boeing will weigh against business investment in the first half of the year. Business confidence weakened in 2019 and election-year uncertainty is likely to be a factor in 2020.
	MANUFACTURING	Activity in the factory sector is expected to be mixed, but generally lackluster, partly reflecting weakness in aircraft production.
	INFLATION	The sub-2% trend in the PCE Price Index is a significant concern for the Fed. Firms have had mixed, but generally limited, success in passing higher costs along.
	LONG-TERM INTEREST RATES	Long-term interest rates have remained low outside of the US, putting downward pressure on US bond yields, but we may see some increase in 2020. Inflation is expected to remain low.
	FISCAL POLICY	Government spending is set to expand roughly in line with the overall economy in 2020. The federal budget deficit has risen, but has not had much of an impact on bond yields or the overall economy.
	REST OF THE WORLD	Global growth was weaker than anticipated in 2019. The advanced economies face demographic challenges. Emerging economies ought to be helped by the Fed's rate cut. However, protectionist policies have been on the rise and remain a notable risk.



## 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	INFORMATION TECHNOLOGY	22.8%	We remain Overweight Information Technology, despite our caution regarding valuation. The cooling of the trade war and bottoming of the semiconductor cycle add confidence to our rating. An acceleration of earnings growth in 2020 provides a catalyst for prices. The sector possesses the most attractive technical momentum, especially the cap-weighted index, of all the sectors.
	HEALTH CARE	14.1%	Relative performance improvement since November coincides with Elizabeth Warren's decline in the polls. Politics remains the wild card for the sector as the Trump administration has yet to release drug pricing proposals, and health care will remain a major topic during the 2020 election season. Despite the headwind, we are comfortable being Overweight. Fundamental trends are healthy and valuation is attractive.
	FINANCIALS	13.1%	We believe the yield curve will stabilize and/or steepen and that longer-dated interest rates will tick modestly higher, which will bode well for the sector. Although earnings growth of 4.8% trails expectations for the S&P 500 in 2020, we feel attractive valuation more than compensates investors for the slower growth.
	COMMUNICATION SERVICES	10.5%	Fundamental trends are attractive, with EPS growth expected to exceed the S&P 500 growth this year and next. Inexpensive valuation and positive price momentum also bode well for the sector. Should government attacks on the two largest weightings in the index (Google and Facebook) increase, the sector may struggle to outperform. For now, we remain Overweight.
	INDUSTRIALS	9.3%	Our expectation for a rebound in manufacturing in 2020, rate cuts by central banks, an improving global economy, and an ebbing of trade tensions all inform our Overweight position. The recovery in EPS growth, along with attractive valuation, are additional tailwinds for the sector. Relative technical gains are likely to be challenging until investors gain confidence that the macro environment will improve. Nonetheless, we still expect improvement in 2020.
EQUAL WEIGHT	CONSUMER DISCRETIONARY	9.8%	The sector's response to improvements with the trade war is disappointing thus far. The cap-weighted index has yet to push to a new high due to heavily weighted positions. The equal-weight index did manage a new high, but relative strength gains are modest thus far. Valuation and expected earnings growth justify interest in the sector, but until relative price momentum improves, we choose to remain Equal Weight.
	ENERGY	4.2%	Crude oil prices are near six-month highs. Concurrently, prices for energy-related stocks are moving higher. The catalysts for the crude oil rally are deeper than expected cuts by OPEC and an easing of trade tensions. Technically, prices are at levels that have served as formidable resistance over the past seven months. With the overall equity market in a positive mode, the short-term rally is likely to continue. Whether it turns into something long-lasting is hard to envision at this point.
UNDERWEIGHT	CONSUMER STAPLES	7.2%	Earnings revision trends continued to move higher in recent weeks. 2020 estimates include 6% EPS growth, a healthy pace for this slow growth sector. However, relative to growth, valuation (PEG) is unattractive. Relative technical trends are weak given that the equity market has favored risk-on sectors. We favor other areas.
	UTILITIES	3.3%	The potential for modestly higher interest rates in the coming months (due to stabilizing manufacturing in the US and an easing of trade tensions) reduces the flows towards safe assets such as Treasuries. Other than the interest rate influence, our opinion is mixed, as elevated valuation counter-balances generally healthy fundamental trends.
	REAL ESTATE	3.0%	We remain Underweight the Real Estate sector based on our belief that interest rates will move modestly higher with easing trade tensions and improving manufacturing. Profit expectations are favorable as revisions stabilized in recent months, and 2020 growth is expected to reach mid-single digits. Valuation is attractive. Nonetheless, the sector's negative correlation to interest rates keeps us sidelined.
	MATERIALS	2.7%	Although we take a pro-cyclical stance with our sector weightings, we keep the cyclical materials sector underweight. The degree of macro recovery may not be as pronounced as usual, given the maturity of the economic cycle and lingering issues such as trade (tariffs remain in place) and Brexit. With relative performance rolling over after the trade announcement, the performance may be signaling the opinion is shared by others.

## DISCLOSURE

All expressions of opinion reflect the judgment of Raymond James & Associates, Inc. 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 com-

modities 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 Shanghai Composite Index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

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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