

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 favourite games — and probably yours — as we look forward to crafting a sustainable investment game plan.

Like players in Cluedo®, ‘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 U.S. 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 U.S. 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 U.S. adults. Now that consumers can join friends for dinner, go to sporting events and concerts, and travel on planes, the U.S. 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 U.S. 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 U.S. seem like a winner, continuing to attract foreign investors and keeping yields lower than valuations may suggest. However, the healthy U.S. 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 favour 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

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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 U.S. 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 realised, 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 U.S. 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 U.S. 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! ■



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The Evolution of Money

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

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

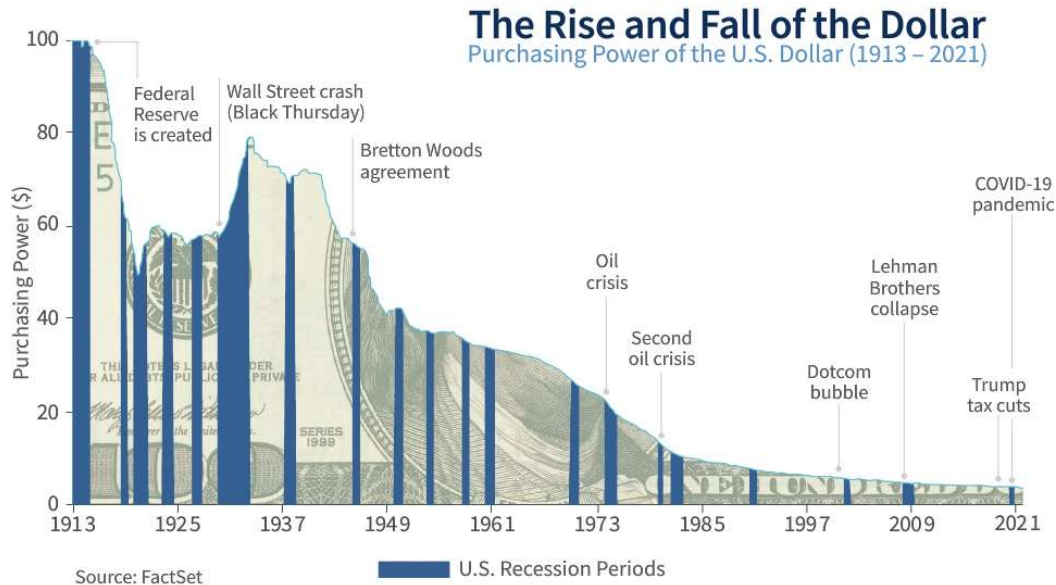
Prior to the development of money, people had to barter, exchanging one type of good for another. An easier way was needed to keep track of who owed what to whom and so systems of ledgers were developed. In some places these IOUs were in tokens, such as shells, beads, or whale teeth, which could be exchanged,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

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

As civilisation 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 U.S. 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 recognise 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 pre-emptively 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 labour 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 summarising 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 mobile phones. 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 U.S. 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 U.S. 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.

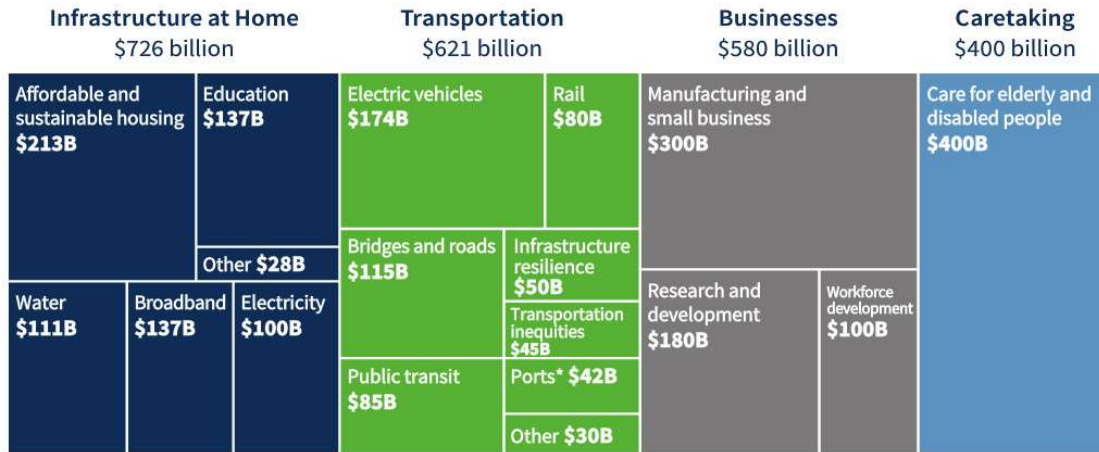
While negotiations are highly in flux and divergent outcomes cannot be fully ruled out, current indications are that an infrastructure package in the \$2 trillion to \$3 trillion range, with about \$1 trillion in deficit spending, is likely by the end of this year or early next year.

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



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 U.S. to remain economically competitive with China. As such, Biden's strategy can be viewed as putting the U.S. 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 \$2-3 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 manoeuvre 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 \$2-3 trillion 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 U.S. 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.



Why The Recent G7 Meeting Was Just A Start

Chris Bailey, *European Strategist*, Raymond James

“ There must be a beginning of any great matter, but the continuing unto the end until it be thoroughly finished yields the true glory” - Francis Drake

The G7 meeting last month in Cornwall will have assisted the local tourist industry for the next few years, but it also reflected some ongoing political and practical evolutions in an always evolving world. Whilst the COVID-19 crisis has meant that economic and societal challenges of the early 2020s will take a number of years to work through, there are many other changes occurring in the world that need addressing.

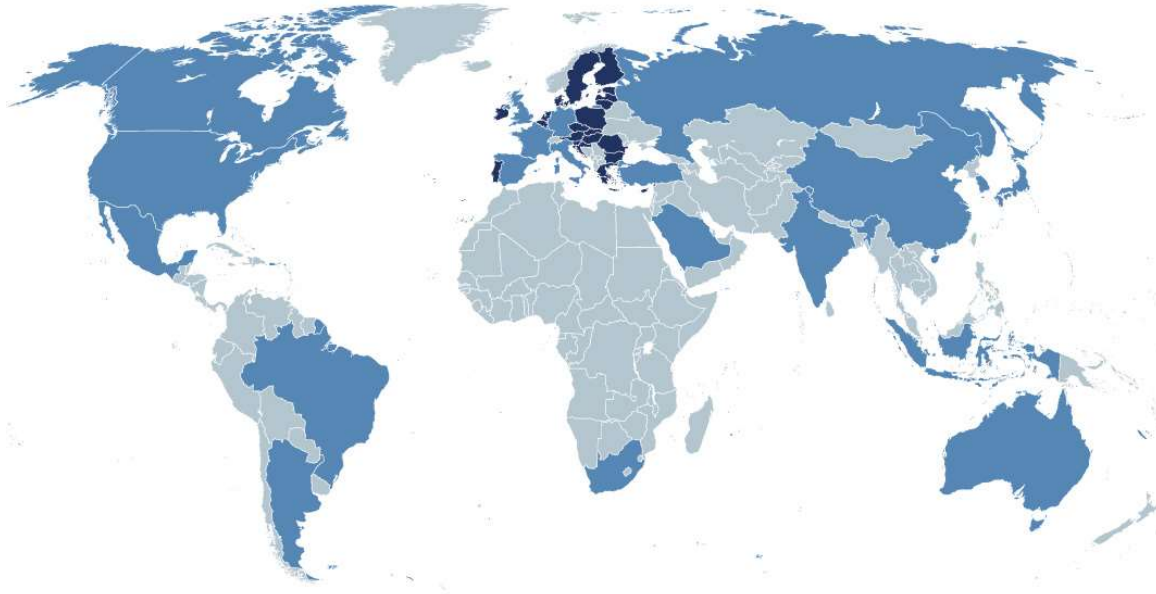
The G7 - or 'Group of Seven' - first met in the early 1970s at the time of a global oil crisis and was originally known as the 'Group of Five' formed by the U.S., U.K., West Germany, Japan, and France. The current grouping of Canada, France, Germany, Italy, Japan, the U.K. and the U.S. is also joined by the president of the European Council and the president of the European Commission. The twenty-five page communiqué last month signed by all members was certainly impressive compared to some previous

meetings held over recent years. Given heightened focus, unsurprisingly, there was a commitment for climate change, a reduction in the use of coal and a target to send at least one billion vaccines to the developing countries.

Collectively this appears a sign of real progress, however - as always - it is easy to talk and harder to deliver. Practical progress comes first with similar conclusions by the broader G20 meetings and ultimately via actual legislative decisions by individual governments, a point regularly made over recent discussions on climate change and the setting of global minimum corporate tax rates. Real progress as always finishes with individual countries making a domestic change, which possibly may have shorter-term local cost and productivity implications. Certainly the current request by many emerging market economies to be given a longer period of time to make climate change progress than their developed market peers, is likely to be a discussion for many years.

G20 ATTENDEES

Argentina, Australia, Brazil, Canada, China, France, Germany, Japan, India, Indonesia, Italy, Mexico, Russia, South Africa, Saudi Arabia, South Korea, Turkey, the United Kingdom, the United States, and the European Union. Spain is also invited as a permanent guest.



And then there is the relationship with China. The G7 meeting last month contained a relatively modest mention of the current controversies in the Far East including the debate over human rights in the Xinjiang province in China or autonomy for Hong Kong. Whilst the current 100th anniversary of the creation of the Chinese Communist Party, has unsurprisingly received little comment from the leaders of the G7 countries, further criticisms have been more mixed outside of the U.S. Whilst American policymakers feel a particular sensitivity towards a country which over the next decade is likely to offer more challenges to their position of global economic leadership, the situation in some other parts of the developed world offers the scope to be very different. European Union leaders - for example - have been more circumspect due to the importance of trade relations, a point made over many quarters by corporate earnings data.

Diplomacy is however at least an attempt to keep corporate trading going and to avoid a war. It was certainly striking to see the new U.S. president meeting his Russian counterpart for a meeting in Switzerland, a few days after both the G7 meeting and the gathering of North Atlantic Treaty Organisation (NATO) countries. Certainly there were times a few decades ago when such relationships were somewhat different.

And this brings us back to the climate change and corporate

taxation issues. G7 leaders may have some quite distinct written conclusions from their time in Cornwall but patently it is just a start and far from a conclusion. On this basis expect the meetings of this group in Germany in 2022, Japan in 2023 and Italy in 2024 to have further disclosures and influences. However before we even get there, do not forget that the U.K. will host the 26th UN Climate Change Conference in Glasgow on 31 October later this year. Insights from a more northern part of the U.K. is set to offer even more discussion. The real key however is still to apply some overt policy decisions. As both financial and political arenas know only too well: what ultimately matters is what you do. ■

KEY TAKEAWAYS:

- The recent G7 meeting in the U.K. saw a lengthy communiqué.
- Further discussions on climate change and corporate taxation.
- The U.S. and Europe are developing different relationships with China.
- Diplomacy continues to support corporate trading with China.



Second Half 2021 U.K./European Equity Outlook:

Chris Bailey, *European Strategist*, Raymond James

“ Basically, the first half of life is writing the text, and the second half is writing the commentary on that ” - Richard Rohr

Equity markets in both the U.K. and Europe have not only achieved notable gains during the first half of 2021, but have also performed much more strongly than expectations. Whilst the perceptions towards COVID-19 vaccine growth potential were already rapidly improving by the first few months of the year, full year 2021 earnings growth expectations were anticipated to be around thirty percent compared to last year. By the end of June, anticipated full year earnings growth for the equity markets in the U.K. and Europe was expected to rise over sixty percent.

So where do we go from here? Whilst anticipated economic growth rates in the U.K. and Europe for full-year 2021 and 2022 are high, the question is more, “what has not already been factored into future equity market expectations?” Three key factors are of particular interest.

The first relates to hopes beyond the next six months. All financial markets always look forward, however only some of those

thoughts have fully factored in next year and even fewer early thought about 2023. Equity markets typically appraise prospects for the next six to eighteen months. So whilst corporate earnings growth hopes for the rest of 2021 are likely to continue to improve, comparisons for the average company as 2022 progresses will become more difficult. Whilst prospective equity market multiple valuations are far from being historically excessive, prospects for next year and beyond have more questions. Inevitably even for equity market investors this starts with local economic growth rates and central bank policy.

Equity markets do not exist in isolation, but are at the mercy of global demand and supply. Heightened demand from global investors for shares in the U.K. and European markets has been notable over recent months. Whilst such raised demand appears to have factored in high levels of optimism, the reality is a little trickier given the high levels of pessimism over recent years from many global investors towards the U.K. and European mar-

STOXX 600: 2021 EARNINGS GROWTH

(Selected Sectors)

Sector	2021 Earnings (Euro Billions)	2021 Growth %
Technology	43	11.9
Industrials	47.7	130.1
Healthcare	67.1	4.0
Financials	133.5	30.3
Consumer (non-cyclical)	62.8	9.3
Consumer (cyclical)	64.2	179.8
Base Materials	64.8	70.4

Source: I/B/E/S data

kets. The recovery of the pound and euro against many other global currencies over the last year has been a reflection of greater confidence, but overall enthusiasm levels are still modest against the norms of five or ten years ago. Once again, it can be easy to overly rely on recent data.

And the third key influence? Unsurprisingly this relates to specific supply issues. The U.K. and European markets are always influenced by their sector specific investment exposures and underlying global market exposure. Certainly by contrast indices in the United States or Hong Kong / China not only have a higher technology sector allocation but also a much greater focus on their respective domestic profitability. On the former observation, sector allocations in the U.K. and European equity markets are higher in the financial, healthcare, basic materials and consumer sectors than technology. Whilst on the latter point - compared to the U.S. market - there is a proportionately heightened impact from the emerging markets. Such different sector exposures helps to explain some of the equity market performance differences over the last decade and the contrasting performance of the last seven or eight months in particular. As for future equity market prospects it highlights to all investors importance of active investment in the U.K. and European equity markets for the rest of this year, next year and beyond.

Year-to-date performance from the U.K. and European equity markets has been strong. Whilst there can always be volatility in financial markets, the debate appears to be more set for next year rather than the rest of this year, given the current scope for improving full year 2021 realities. Prospects for 2022 and beyond however remains more of a debate, especially if global investors' confidence continues to grow. Active investment will be more and more critical for equity markets in the U.K. and Europe. ■

KEY TAKEAWAYS:

- U.K. and European stock markets have performed well year-to-date.
- Prospects remain strong for 2021 but markets always look forward.
- Global investors are set to keep raised allocation levels.
- Heightened active investment focus.



Q&A - Inflation: The Year of Disbelief

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Setting the stage:

If 2020 was the year to forget, might 2021 be the year of disbelief? News headlines, certainly financial news headlines are more often than not being driven by shrill fears associated with the return of an inflationary beast that most, if not all, had believed to have been conquered forty or fifty years ago. What makes these fears all the more remarkable is the fact that inflationary pressure, as measured by Consumer Price Inflation (CPI) metrics is not everywhere. Yes, it is apparent in the United States and in the U.K. too. But in Europe and in Japan it is nowhere to be seen, with prevailing CPI metrics are comfortably below central bank target levels.

Q: Is this inflationary “episode” being driven by the so-called “reflation trade”?

A: Monetary theorists have always stated that if one produces excessive stimulus, through interest rate cuts, balance sheet expansion and especially when combined with significant fiscal stimulus, then inflation will come storming back. Economic purists, especially those of a monetarist persuasion, will forever argue that inflation is a phenomenon created by monetary policies. If a central bank prints money (expands the money supply), then an inflationary episode cannot be far behind. Yet, the great counter-weight to this view, historically, was globalisation. The inclusion of increasing numbers of emerging market economies into the manufacturing supply chains of the developed world worked incredibly well at keeping prices low.

Q: Is it true that not all prices are rising?

A: Absolutely! Whilst much attention has inevitably focused on certain specific “hot” pockets, such as used automotive vehicles and commodity prices, the prices of other items haven’t budged. Taking U.S. CPI as an example, of the 70 items comprising the “basket”, only five are seeing prices roaring higher while thirty are seeing prices steady or still falling. Something similar is happening in the U.K. too. It is perhaps important to add that other than owner equivalent rents, house prices are generally excluded from inflation calculations (although there is a live debate at the European Central Bank about this subject right now). For this important reason, it seems highly likely that CPI metrics are not telling the whole story. The cost of living is rising, but inflation is not!

Q: Does much of the debate about inflation surround a possible central bank policy response?

A: This is clearly a hugely important point for investors in financial assets. What should be highlighted from the outset is central bankers' obsession with trying to evolve a (developed) economy that produces inflation at an average annual rate of 2%. What is extraordinary about this target is how it was calculated or deemed to be appropriate. Despite volumes of erudite journals, millions of hours of lectures and armies of PhDs all working assiduously on the matter, the 2% dropping out of the end of the pipe is, in fact, a number created out of thin air. Is it appropriate that policy settings be adjusted simply on the basis that inflationary pressure has, perhaps temporarily as central bankers tell us, overshot this arbitrary line in the sand?

Q: Why hasn't inflation been booming for years?

A: Other than the above reasons, since the bursting of the tech bubble developed economies have operated through 15 of 21 years with interest rates near zero, whilst also having central banks implement quantitative easing. Yet during those same years underlying CPI (excluding food and energy) has exceeded the magical 2% threshold in only three of them in the U.S. and never in Japan or the Eurozone. Monetarists might argue that, even at or close to zero (and negative in Japan and the Eurozone) interest rates were simply not cut enough and not enough electronic money was printed! In fact, the opposite to that which was thought necessary has occurred. Instead of historic stimulus resulting in a spending splurge, ever larger amounts of private capital has decided not to participate in the real economy but been parked elsewhere. The velocity of money has collapsed and financial asset prices have sky-rocketed.

Quantitative easing is a deliberate, if indirect, means by which central banks suppress interest rates for as long as possible. In so doing, central banks are effectively funding mountainous (and rising) government budget deficits and debt rollovers, essential if countries are not to default. Yet all these newly created reserves are simply clogging up the banking system and are not being released by new loans or credit creation. It is this "clogged up" part of the QE process that suggests that the apparent rise in inflation we are now seeing is not really occurring due to monetary policy.

Q: So, if not monetary policy then what?

A: We need to look at the "other side" of economic theory, in short-hand "Keynesian" or fiscal policy. Specifically, this refers to the fact that across developed economies, to a lesser or greater extent, many businesses and households have either directly or indirectly received payment from the government. Initially this

was intended to act as income replacement due to pandemic-induced shutdown, yet now it is well known that these amounts have been far greater than what might have otherwise been received in wages. This has resulted in the flood of spending underlying the global economy's rapid recovery. At the same time, enforced business shutdown has forced the manufacture and distribution of many items to be disrupted, notably silicon chips, essential in the smooth evolution of an economic cycle. The outcome is lower supply smacking straight into higher demand for goods and services. The result is rising prices and apparent inflation.

Q: If that is right, then the inevitable conclusion to this episode must be that once supply and demand are back in equilibrium the inflation we are seeing should subside?

A: Exactly! The combination of more and more businesses reopening should, in time, result in a return to pre-pandemic supply. Furthermore, once government support for businesses and households concludes, demand should very likely retreat from today's elevated levels. This should have the effect of driving prices lower.

CONCLUSION

Firstly, central bank monetary policy is not creating inflation. Secondly, fiscal policy and especially government handouts are creating inflation. Thirdly, global shutdowns one year ago are creating easy comparatives, but these "base effects" will diminish over time. Fourthly, shutdowns have created supply disruptions which, unless becoming permanent, will diminish as supply comes back on line. Fifthly, and lastly, central banks must set policy not for the here and now but for the months ahead. They must also play their part in minimising medium or longer term economic risk. If activity levels dwindle as fiscal stimulus is withdrawn (to be replaced by fiscal tightening), ultra-accommodative monetary policy must act as the counter-weight. The bigger risk is not transient inflation now, but sustained economic weakness in the future. ■

KEY TAKEAWAYS:

- Central bank monetary policy is not creating inflation.
- Fiscal policy and especially government handouts are creating inflation.
- Global shutdowns one year ago are creating easy comparatives but "base effects" will diminish over time.
- Central banks must set policy for the months ahead.
- The bigger risk is not transient inflation now, but sustained economic weakness in the future.

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