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INVESTMENT STRATEGY QUARTERLY

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2016: A year of worry or opportunity for investors?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails" - William Arthur Ward

2015 was hardly a classic year for most investors but it certainly represented a return to primacy of active investment acumen versus a more passive index-led approach - a theme I would anticipate continuing this year (more on this later).

As measured by the (necessarily imperfect) indicator of short term equity market returns, 2016 has started not with a bang, nor a whimper, but downright pessimism. Monday 4 January saw the worst opening day of the year for the FTSE-100 since the year 2000, the EuroStoxx 600 index since 1987, the Dow Jones Industrial Average since 2008 and the Chinese mainland indices since at least the 1990s.

This heightened volatility had its origins in China where a number of the issues - manufacturing sector slowdown and a weakening value of the Chinese yuan - which had afflicted the country's stock market in the second half of 2015 - returned as concerns. However the early 2016 data was not all bad news as the services sector continued to expand.

Maybe it was just local investor sentiment or – as the legendary economist John Maynard Keynes once put it – animal spirits. It is certainly true that investors enter 2016 more downbeat than usual. Investor sentiment surveys in the United States show many more 'neutrals' than 'bulls' or 'bears', consensus corporate earnings growth expectations are more mid-single digit percentage growth in magnitude than the usual mid-teens percentage and sovereign bond yields globally remain close to the all-time lows many markets achieved in 2015.

However despite all the early year angst there are beacons of hope. Lowered sentiment levels reduce the barriers to potential outperformance and central banks are not sitting idly by either. Whilst the Federal Reserve has edged up interest rates from the perception that the US economy has suitably recovered to warrant it, the policy direction in most other countries is towards more loosening supplemented by the central banks in the Eurozone, Japan and quite possibly China by new stimulus measures at the margin. Such stimulus generally helps local economies and financial markets. As an early January global manufacturing report noted about the Eurozone: 'A return to growth in Greece meant all of the member states of the currency union covered by the survey were in concurrent expansion for the first time since April 2014'.

2016 FORECAST WORLD GDP	
North America	2.3%
Western Europe	1.8%
Eastern Europe	1.2%
Middle East/North Africa	3%
Japan	1.7%
Asia ex Japan	5.4%
Latin America	0.6%
Sub-Saharan Africa	3.5%
Australasia	2.6%

Source: Economist.com

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General global economic balance would probably also be helped by a lower value of the US dollar, bringing relief to emerging markets and commodity grades and encouraging more focus on productivity enhancing reform in the Eurozone and Japan. As a single factor the level of the US dollar is probably the most important determinant concerning the extent of global financial market returns.

For the balance of the first quarter influential events are likely to include global corporate earnings disclosures and the confidence level of investors in the policy making capabilities of central banks. Policy initiatives and comments by the People's Bank of China and the Federal Reserve will be considered carefully in particular given the sensitivity to perceived Chinese economic performance and future US interest rate policy. At the time of writing such confidence levels remain in flux.

It is unlikely that the sharp falls seen on the first trading day of 2016 are fully representative of the full year. Lowered expectations and policy stimulus options provide support. It is again likely to be a year for active, flexible investors. In short, 2016 is a year when moments of worry provide opportunities.

KEY TAKEAWAYS:

- A volatile first trading week of 2016 reflects investor concerns about global growth and central bank credibility.
- The economic backdrop is not uniformly poor however. A key variable to watch is likely to be the US dollar.
- The correct mind-set for 2016 is that volatility can provide opportunities.

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

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2016 Economic Outlook

Upside opportunities, with some downside risks

Scott J. Brown, Ph.D., chief economist, equity research, outlines his expectations for the US economy in 2016.

> "The Fed doesn't have to hit the brakes, but it does need to begin taking its foot off the accelerator."

The 2016 outlook is dominated by the same themes that prevailed during the second half of 2015. Domestic demand is expected to remain strong, particularly in the first half of the year, but overall growth is likely to be somewhat restrained by the impact of sluggish global growth and a strong dollar.

Investors have expressed some concerns about tighter monetary policy, but worries are likely overdone. Expected to be gradual, the pace of the Federal Reserve Bank's (Fed) rate increases reflects an economy moving toward its long-term potential. Even with higher short-term interest rates, Fed policy should remain accommodative over the course of 2016. Investors are likely to focus on the presidential election in the second half of the year, perhaps with some trepidation.

DOMESTIC GROWTH

In its regular reports on gross domestic product (GDP), the Bureau of Economic Analysis has begun presenting a new output measure – private domestic final purchases (PDFP). A smoother gauge of underlying domestic demand, this measure is made up of consumer spending, business fixed investment and residential investment, and accounts for 85% of GDP. It excludes net exports, change in inventories and government – three components that are volatile quarter to quarter. Adjusted for inflation, PDFP rose 3.2% over the four quarters ending September 30, 2015, according to the government's second estimate of third quarter growth. In contrast, real GDP was reported to have risen 2.2% over the same period, largely reflecting an increased drag from foreign trade.

THE JOB MARKET

Six and a half years into the economic recovery, the slack in the job market – generated in the financial crisis – has been largely, but not completely, reduced. While there are still signs of slack, including elevated levels of long-term unemployment, high involuntary part-time employment, and lackluster growth in average wages, there should be a lot less slack a year from now. The Fed has to set monetary policy with an eye to where the economy will be in 12 to 18 months. In that regard, most Fed officials believe it's appropriate to begin moving to a more normal policy position. The Fed doesn't have to hit the brakes, but it does need to begin taking its foot off the accelerator.

MONETARY POLICY

Financial market participants have been anxious about the timing of the first rate increase, but Fed officials have stressed that the pace of policy tightening will be much more important than the timing of the initial move. The Fed has continued to emphasize that monetary policy will still be accommodative after it begins to raise rates, future policy moves will be data dependent, and economic conditions are expected to evolve in such a way as to warrant a gradual path of rate increases.

INFLATION

Low in 2015, inflation was held down by a sharp decline in gasoline prices. Excluding food and energy, the Consumer Price Index (CPI) rose about 2%, with half of that increase concentrated in higher shelter costs (specifically in rent or rental equivalents). The Personal Consumption Expenditure Price Index (PCE), the Fed's

chief inflation measure, has a smaller weighting on shelter with a core rate trending below 1.4% versus the Fed's official goal of 2%. Fed officials generally expect consumer price inflation to head higher as the impact of lower commodity prices fades. However, depending on how much is already factored into the markets, tighter Fed policy is likely to put some further downward pressure on commodity prices in the near term. While inflation in consumer goods is expected to remain low, services account for a majority of consumer spending, and inflation in services is driven largely by wage growth.

CONSUMER SPENDING

Boosted by strong job growth and the increase in purchasing power associated with the drop in gasoline prices, consumer spending was strong in 2015. However, lower gasoline prices had a varied impact across households. For those at the upper end of the income scale, it doesn't matter how much it costs to fill up since their spending isn't going to change much. Those at the lower end of the income scale tend to drive less, so they are going to see less of a benefit from low gasoline prices. However, those in the middle have benefited significantly, although budgets have likely been strained by other factors that include rising rent and healthcare costs.

CORPORATE EARNINGS AND MANUFACTURING

Corporate earnings from the rest of the world were restrained by slower global growth and the impact of a stronger dollar in 2015 – for any given level of foreign earnings, a stronger greenback will reduce the dollar value of those earnings. In response, many of those firms have reduced capital expenditures. Still, domestic demand should be strong enough to sustain a moderate pace of business fixed investment in 2016.

Manufacturing activity has also reflected the mix of domestic strength and global weakness. Auto sales and production have been brisk, aided by strong job growth and relatively easy credit for auto loans.

HOUSING

Residential housing has continued to recover, supported by strong job growth, but activity has remained below what may be considered normal. Builders cited a number of restraints in recent years, but these should fade over time. Despite significant job gains over the last several quarters, the market for start-up homeowners has not recovered much but should improve as wage growth picks up. Bank credit to mortgage borrowers may get gradually easier even as the Fed begins to raise short-term interest rates.

GLOBAL GROWTH

For many years, emerging economies have made a compelling story for investors. China, India, and the rest of developing Asia, along with Latin America and countries in Eastern Europe, have been growing rapidly since the financial crisis and were expected to account for much of global economic growth over the next couple of decades. With the exception of India, these economies have softened in recent quarters, putting downward pressure on commodities and leading to slower growth in commodity exporters. The longer-term outlook for emerging economies is still promising, but the post-recovery pace of growth is likely to be lower than was expected a few years ago. China's economy is transitioning from one led by export growth and infrastructure spending to one led by private domestic demand. China's capital markets will have to become more market-determined in the years ahead. These transitions are likely to be challenging and financial conditions may be volatile in the months ahead. Unfortunately, the economic data coming out of China are unreliable, making it difficult to generate an accurate assessment and adding to the overall uncertainty in the global economic outlook.

The U.S. economy is mostly self-contained. China, for example, accounts for less than 8% of U.S. exports (or less than 1% of U.S. GDP). However, China and other emerging economies have been a rapidly growing market for U.S. exporters. The Fed bases monetary policy decisions on the domestic economic outlook, but officials do need to take into account how what's happening in the rest of the world influences our economy. In the near term, that may imply reduced demand for U.S. exports (hence, somewhat slower GDP growth) and a softer trend in inflation, but these impacts are viewed as transitional.

KEY TAKEAWAYS:

- The 2016 outlook is dominated by the same themes that prevailed during the second half of 2015.
- Domestic demand is expected to remain strong, particularly in the first half of the year, but overall growth is likely to be restrained somewhat by the impact of sluggish global growth and a strong dollar.
- The pace of Fed rate increases is expected to be gradual and reflects an economy moving toward its long-term potential. Even with higher short-term interest rates, Fed policy should remain accommodative over the course of 2016.
- The longer-term outlook for emerging economies is still promising, but the post-recovery pace of growth is likely to be lower than expected a few years ago.

THE RISE OF SHORT-TERM INTEREST RATES

Federal Reserve policymakers raised short-term interest rates for the first time in nine and a half years, citing "considerable improvement in the labor market" and confidence that inflation will return to the Fed's long-term goal of 2%.

The Fed noted that monetary policy will still be accommodative after this move, supporting further improvement in the job market. Future policy action will be data-dependent, but the pace of interest rate increases should be gradual. Senior Fed officials generally expect an increase of a full percent over the course of 2016, or a quarter percent each quarter.

The Fed's initial rate increase should not have a large impact on the economy in the near term. Deposit rates will remain low, lagging Fed moves on the way up. Longer-term interest rates, including home mortgage rates, may move a bit higher, but not sharply.

After a considerable period of financial market anxiety regarding the timing of the Fed's initial rate hike, including adverse reactions in emerging economies, the Fed's policy outlook should be largely factored in. Looking ahead, financial market participants will remain focused on a variety of economic indicators in early 2016, including the pace of job growth and developments overseas.

US ECONOMIC SNAPSHOT

The economic outlook for 2016 is similar to what we saw in the second half of 2015. The strong dollar and soft global growth should continue to weigh against U.S. exporters, while low oil prices will further dampen energy exploration. The rest of the economy appears to be in good shape, with a strong job market and better purchasing power supporting consumer spending growth. Residential homebuilding should pick up. Business fixed investment is likely to be mixed, but generally moderate. Fed policy is expected to gradually be less accommodative.

SCOTT BROWN
Chief Economist,
Equity Research

STATUS	ECONOMIC INDICATOR	COMMENTARY
POSITIVE OUTLOOK	GROWTH	Domestic demand should remain strong, as measured by private domestic final purchases, yet overall growth is likely subject to some drag from a wider trade deficit.
	EMPLOYMENT	Job losses remain limited. New hiring should continue, but the pace of growth is likely to slow somewhat relative to the last couple of years (due to supply constraints).
	CONSUMER SPENDING	Job growth has remained strong, but the pace of job gains is expected to slow as the labor market tightens. Wage growth has been relatively lackluster in recent quarters, but should pick up. Low gasoline prices have boosted purchasing power, but the impact should fade (and has been offset by higher rents and other strains in the household sector).
	HOUSING AND CONSTRUCTION	Supply constraints (high costs and a lack of skilled labor, among others) have been a restraint for homebuilders and tight credit has thwarted potential first-time buyers, but strong job growth is supportive. Mortgage rates may drift a bit higher, but not enough to hold back the overall recovery in the housing sector.
	INFLATION	Tighter Fed policy may put some further upward pressure on the dollar, helping to keep the cost of imported raw materials and finished goods down. Inflation in services has been running higher, but is mostly concentrated in rents.
	THE U.S. DOLLAR	In the short run, exchange rate movements largely reflect central bank policies. With the Fed expected to tighten further and others likely to remain "easy," the dollar may firm a bit more. However, much of this should already be priced in to the currency market.
NEUTRAL OUTLOOK	MONETARY POLICY	Expecting further improvement in the job market and an eventual rise in inflation (back to the Fed's 2% goal), the central bank is likely to raise short-term interest rates gradually, a quarter percent every three months (or possibly a bit slower if the Fed falls short of its goals or financial instability increases).
	BUSINESS INVESTMENT	Pressures on exporters and in energy production are headwinds, but the domestic economy is expected to be strong enough to sustain a moderate pace of capital spending.
	MANUFACTURING	The manufacturing outlook is mixed across industries. Healthy year-over-year growth in auto production is expected, but factory output is generally lackluster otherwise. The strong dollar has dampened exports.
	LONG-TERM INTEREST RATES	Long-term interest rates should trend gradually higher as the economy improves, but a sharp rise is not likely (as inflation is expected to remain relatively low by historical standards). Some of the global flight to safety may wear off as the year progresses.
NEGATIVE OUTLOOK	REST OF THE WORLD	Global outlooks are a mixed bag, with advanced economies expected to fare better. Some emerging economies, Latin America in particular, will continue to struggle this year. Low commodity prices have been a major setback for exporters of raw materials, but low prices are beneficial to commodity importers and should sow the seeds for better global growth down the line.
WILD CARDS		Watch financial conditions closely in early 2016 for signs of an over-reaction to less-accommodative Fed policy. The presidential race could become an important issue for the stock market in the second half of the year.

Answers await for the global policy divide

Chris Bailey, European strategist, Raymond James Euro Equities,* shares thoughts on the outlook for monetary policy worldwide.

THE U.S. BEGINS TIGHTENING

At the last count, 2015 saw 67 central bank, interest-rate reductions – a remarkable statistic approximately six years from the formal end of the global financial crisis.

> "The reality is that different economies are traveling at different speeds."

In a world of relatively free capital flows among the big western powers, there are consequences to tapering monetary policy. Even before it turns into an overt interest rate increase, tapering is a form of tightening – with the rise in the U.S. dollar over the last year a testament to this notion. While the U.S. economy may be able to absorb such an increase, other economies that are heavy on dollar-denominated debt, or are attempting to maintain currency pegs to the U.S. dollar, have struggled to handle the change.

A large proportion of central banks which cut interest rates last year were troubled emerging markets attempting to offset the losses associated with a U.S. monetary policy progressively moving away from extreme accommodation, a policy which supported these economies in recent years.

EUROPE CONTINUES EASING

And then, of course, there is the euro zone. Despite an overall sense of reluctance, European policy makers finally implemented quantitative easing in the first quarter of 2015, causing a subsequent shift to negative interest rates and a lengthening of the anticipated duration of central bank balance sheet expansion. It's little wonder that the euro experienced multi-year lows against the dollar at various points throughout 2015.

The reality is that different economies are traveling at different speeds. Economists will likely reflect on monetary policy throughout the global financial crisis and conclude that those central banks that moved early by cutting interest rates and employing unorthodox quantitative easing policies – notably the Federal Reserve and the Bank of England – generated the fastest rates of economic growth over recent years.

With such growth comes the "prize" of tentative steps toward more conventional "normalized" policy. This process begins with the end of quantitative easing followed by the notion of an increase in interest rates from ultra-low levels.

UP, DOWN AND ALL AROUND

In short, it appears that the overt differences between current monetary policy cycles of the U.S. and Europe, as well as large swathes of emerging markets, should continue to escalate over the next few months. This divergence places further pressure on exchange rates and global economic growth, and increases the potential for financial market volatility going forward.

So, does a difficult year await? Before jumping to such a conclusion, a final observation from the last three U.S. monetary policy tightening cycles may help provide perspective on what lies ahead. In all three cases, the U.S. dollar rallied prior to the initial interest rate hike, then weakened in the following three-to-six months. Pressured emerging market economies and commodity-exporting nations would welcome such a move and, in Europe, it could help move economic discussions away from exports and cheap currencies toward economic reform and boosting regional consumption levels.

It looks as if, in a world of greater monetary policy variance, equity market participants and economic strategists alike will be watching some of the key exchange rate movements more closely than usual.

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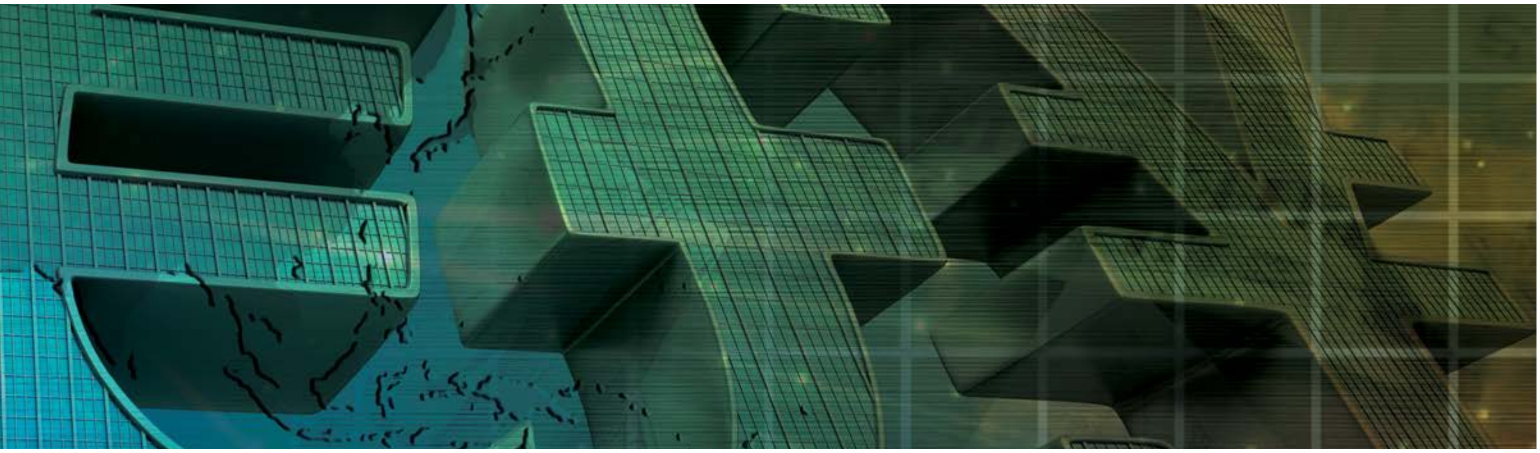
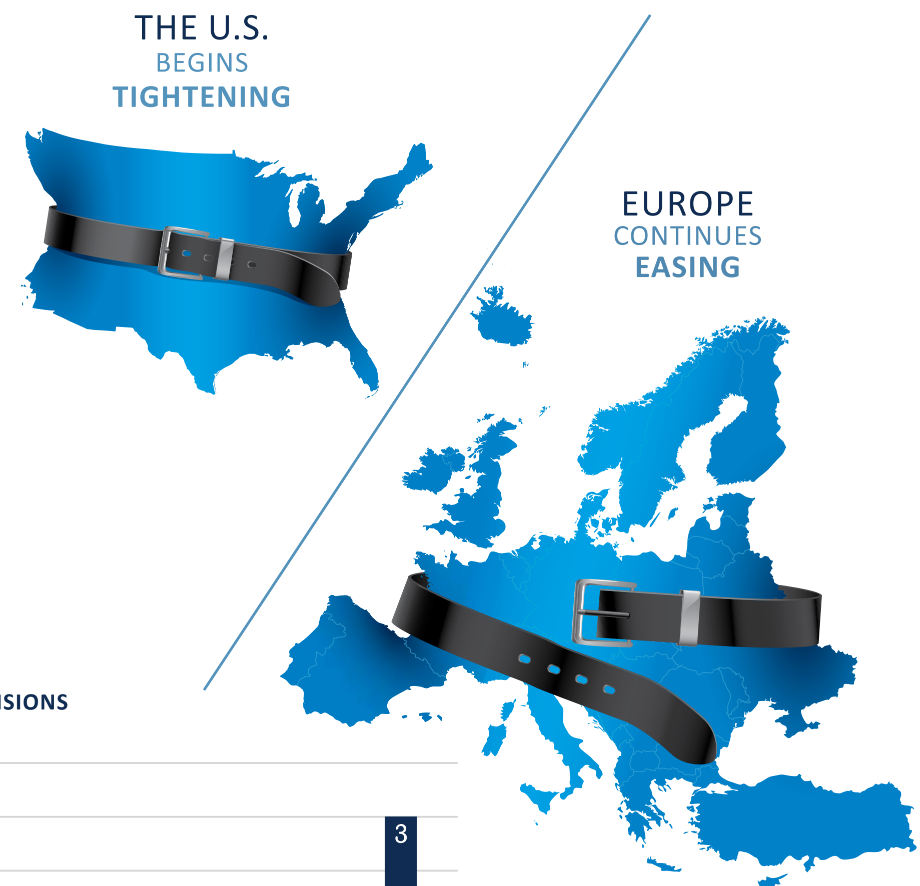


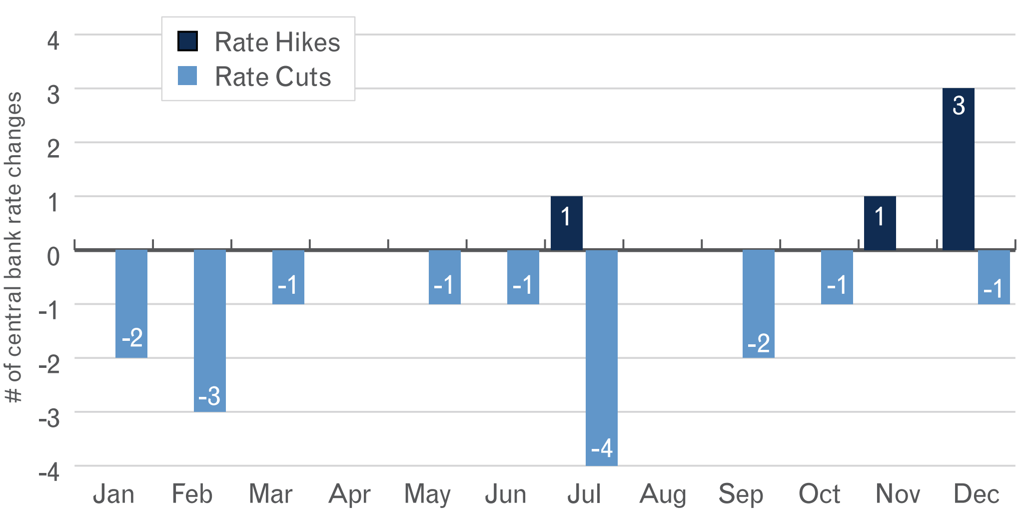
KEY TAKEAWAYS:

- Economies that are heavy on dollar-denominated debt, or are attempting to maintain currency pegs to the U.S. dollar, have struggled to handle the strengthening currency.
- Divergence in global monetary policy places further pressure on exchange rates and global economic growth, and increases the potential for financial market volatility going forward.
- A slowing U.S. dollar would help shift Europe's attention away from cheap exports and towards structural reform.

DIVERGENCE IN MONETARY POLICY CYCLES



2015 CENTRAL BANK INTEREST RATE DECISIONS



Source: cbrates.com

This chart includes 21 of the largest central banks with significant influence on global growth.

Light at the end of the tunnel for oil; natural gas still in the dark

Pavel Molchanov, energy analyst, equity research, sheds some light on the energy outlook for 2016.

The brutal 18-month downturn for the global oil market has a silver lining – as an old industry saying goes, “the cure for low oil prices is low oil prices.” A painful and protracted austerity – drilling halted, projects canceled, workers laid off, even outright bankruptcies – carries the seeds of an oil price recovery toward the end of 2016 and ramping up in 2017.

> "After lingering weakness in the first half of 2016, we project both Brent and WTI crude oil rebounding into the $60-plus range in the second half."

OIL RECOVERY NEAR, SUPPLY RISKS REMAIN ELEVATED

The long-standing theme in commodity markets – energy and non-energy alike – is that they overshoot on both the upside and the downside. While it’s hard to say for sure whether the recent market decline’s brief encounter with below $40 per barrel prices marked a long-term bottom, what is clear is that prices below $50 do not generate acceptable drilling economics in the vast majority of non-OPEC geographies. The price environment will eventually have to recover to support a more sustainable level of industry-wide investment.

Given the extent to which capital budgets were curtailed in 2015, and likely even more so in 2016, we think it will be essential for a higher level of spending to materialize in 2017. To enable that, prices will have to strengthen in advance. After lingering weakness in the first half of 2016, we project both Brent and WTI crude oil rebounding into the $60-plus range in the second half.

Investors should keep in mind that stocks tend to react before the commodity does, so it’s not advisable to get too cute with timing. We also think the risk of a potential oil supply disruption remains much higher than the oil market is currently discounting. Should unexpected supply disruptions emerge – in the Middle East, for example an all-out war with ISIS, or perhaps elsewhere – that would almost certainly create upside to our price forecast.

A BEARISH PICTURE FOR NATURAL GAS

Natural gas presents a different picture for the coming year, in a decidedly bearish way. In North America, production growth is outstripping demand growth, and not by a small margin. On the supply side, increased pipeline takeaway capacity in the Northeast during 2016 to 2018 is easing pricing pressures and inducing producers to complete more wells from inventory; and continued increases in well productivity and drilling efficiencies are allowing operators to maintain production with fewer rigs.

On the demand side, development of industrial gas demand has been frustratingly slow, and the ramp-up in solar and wind has been eating into gas’s market share gains in the U.S. As such, we project a decline in Henry Hub gas prices in 2016 to a more than 10-year low of $2.00/Mcf* – in contrast to the recovery we envision for oil.

While gas prices are structurally higher in Europe and Asia-Pacific, market fundamentals in these regions are not in great shape either. European gas demand is languishing near 20-year lows – quite a stunning statistic. Japanese demand for liquefied natural gas (LNG) is under pressure as nuclear reactors are gradually brought back online, and Chinese LNG demand is not growing as robustly as the industry would have hoped.

In the meantime, six Australian LNG export projects will be starting up over the next 24 months, boosting global liquefaction capacity by nearly 20%. LNG exports from the U.S. Gulf Coast are also about to get underway, though it will not be enough to boost domestic gas prices until 2018 at the earliest.

*Mcf is an abbreviation denoting a thousand cubic feet of natural gas.

THE IMPACT OF REGULATION

Above and beyond the usual commodity price volatility, the increasingly widespread regulation of carbon emissions around the world is another important theme energy investors will need to be aware of in 2016 – and, even more so, in subsequent years.

Following the United Nations climate conference (COP21) in December, there is stronger international cooperation on emissions, encompassing both industrialized and developing countries. Individual countries will set their own policies on how to reduce emissions, such as carbon taxes (e.g., Japan and Mexico) and/or cap-and-trade policies (e.g., European Union and China).

Although the impact of such policies on specific energy sources is not always going to be predictable, in general the beneficiaries will be the zero/low-carbon sources, including various types of renewables, nuclear power in a limited number of countries and, in some cases, natural gas. For example, solar penetration in the U.S. electricity market is on the cusp of reaching 1%, while in Germany and Italy it is already above 7%. Energy efficiency and grid modernization investments are also likely to accelerate.

Given the supply glut going into 2016, energy prices should remain, broadly speaking, low. That said, we are more optimistic on a six- to 12-month recovery in oil prices as compared to natural gas prices. Selectivity is important when investing in this sector – but after five years of energy's underperformance versus the S&P 500, we think 2016 will, for the most part, be a better year for energy stocks.

KEY TAKEAWAYS:

- Due to supply going into 2016, energy prices should remain low, and we are more optimistic on a six- to 12-month recovery in oil prices compared to natural gas.
- Selectivity is important when investing in this sector but, for the most part, 2016 will be a better year for energy stocks.
- An important theme, besides price volatility, that energy investors will need to be aware of is the increasingly widespread regulation of carbon emissions around the world.

Should income investors prefer bonds, equities or cash?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

The greatest challenge for many investors today centres on the debate over where to source sustainable flows of income. Ageing populations need income and groaning pension schemes have struggled to meet their liabilities. The prevailing trend in pension fund management has been to respond to this by increasing fixed interest allocations in an attempt to match cash flows and reduce the threat of underfunding. Individual investors however have more flexibility than pension fund managers and, correctly, should be asking the question: 'for income over the rest of this decade should I prefer bonds, equities or cash?'

> "Understanding the underlying financial position and managerial motivations has become ever more important in today's financial market backdrop. Research matters. "

Two years ago benchmark UK gilts yielded just over 3%. At the end of January last year that yield had compressed to just 1.33%. Even though the equivalent rate today is just under 2% it pales against the above 4% yield currently available from equities. At a headline basis – with cash interest rates at negligible levels due to rock bottom interest rates - equities look a clear winner in the income stakes.

Equities have one problem however - they are not fixed principal investments. However whilst the value of equities do go up and down this is counterbalanced by the growth potential embedded in many of them. In short over a full market cycle the volatility of the stock market should not be a barrier for all but the most conservative income seeking investors.

So how about the pick-up yield premium currently being enjoyed by equities? The key here is dividend cover or the number of times dividend payable is covered by earnings. Currently the FTSE-100 index has a dividend cover of just over 1.4 times which is close enough to the parity threshold to raise concerns.

A deeper look highlights the reality of the situation: index-level statistics are only a blended snapshot. Recently many large cap luminaries have debased or even suspended their dividend payments due to difficult business challenges in traditionally high yielding areas like resources or banking stocks. Such pressures are unlikely to go away quickly in today's world of below-trend economic growth. However cutting dividend payments comes at a cost typically including a falling share price, a volatile shareholder base and ire towards the management team – after all there are plenty of institutional and individual investors chasing income.

In short, understanding the underlying financial position and managerial motivations has become ever more important in today's financial market backdrop. Research matters.

So the time-pressured investor chooses the duller yielding but less complicated fixed income option given that the UK government are highly likely to stop paying their bond coupons? If an investor was happy with an income level half that offered by the UK's main equity market that would be fine – but most investors will want more and this is why the higher yielding attractions in the corporate bond market have attracted much greater allocation attention in the last few years. Of course as soon as you talk about corporate bonds then the research routines required for equity income start again.

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

In summary income investors today are having to work harder for less reward…and this is where the attractions of cash come into play. Unsurprisingly cash is currently the lowest yielding asset but it is also the least volatile. 2016 is likely to see transitory volatility in both the equity and bond markets as debates over economic growth, budget deficits and inflation rage. The use of cash as a temporary safe haven asset may increase in popularity as income investors await more volatile conditions – and quite possibly higher income yields – to invest. Such an approach requires some market timing skills, but in today's lower yielding world the opportunity cost is not as high as a few years back. The only trouble is that the propensity to reinvest at the height of volatility is unfortunately typically low.

"2016 is likely to see transitory volatility in both the equity and bond markets as debates over economic growth, budget deficits and inflation rage."

Income investing in 2016: full of new and changing challenges.

KEY TAKEAWAYS:

- Equities offer the highest headline yields but require careful and ongoing fundamental analysis.
- The shift to corporate bonds for their yield pick-up against sovereign bonds also requires "equity-like" analytical skills.
- Cash as a tactical asset may continue to have a role for more active income investors not afraid of market timing.

Will the Bank of England raise UK rates in 2016?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

The Federal Reserve's decision in December to increase US interest rates for the first time since mid-2006 naturally raised speculation that the Bank of England were planning to do something similar.

In economic policy terms, 81 months is a long period of time. It has been this many months since the Bank of England last changed interest rates, to 0.5%. As David Miles, a recently retired member of the UK's Monetary Policy Committee (MPC), noted in a speech last July, after personally participating in 74 meetings of masterly inaction:

"*I have not yet voted for a single change in the Bank Rate - a potential source of some embarrassment as I ponder in years to come the question 'what did you do on the MPC?'. A simple answer might be - vote for hundreds of billions of asset purchases (so not exactly 'er…nothing'). But I think a better answer might be that I heeded a good piece of advice, which is: don't just do something, stand there (and think)…*"

New thinking is ongoing however. The Governor of the Bank of England, Mark Carney, in the early August's post-MPC meeting press conference noted that "The likely timing of the first rate increase is drawing closer. However, the precise timing cannot be predicted in advance. It will be data dependent."

Data dependency is one of those phrases that central bankers utter when they don't want to commit themselves too tightly to a precise forecast or expectation given it is stating the obvious. The challenge however for the Bank of England decision makers is that recent economic data for the UK has shifted from generally good to a little mixed.

UK BASE INTEREST RATES

DATE CHANGED	RATE
Thu, 05 Mar 2009	0.5
Thu, 05 Feb 2009	1
Thu, 08 Jan 2009	1.5
Thu, 04 Dec 2008	2
Thu, 06 Nov 2008	3
Wed, 08 Oct 2008	4.5
Thu, 10 Apr 2008	5
Thu, 07 Feb 2008	5.25
Thu, 06 Dec 2007	5.5
Thu, 05 Jul 2007	5.75
Thu, 10 May 2007	5.5
Thu, 11 Jan 2007	5.25
Thu, 09 Nov 2006	5
Thu, 03 Aug 2006	4.75
Thu, 04 Aug 2005	4.5

Source: BankofEngland.co.uk

At the heart of any decision however is inflation – where control of at or below 2% has been the primary target of the Bank of England since it was made independent. Aided by plummeting energy prices official inflation statistics are currently very muted – and this has driven policy thinking in different directions.

*An affiliate of Raymond James & Associates and Raymond James Financial.

A few weeks ago Mr Carney subtly updated his "data dependant" thoughts by observing that "The Bank of England…is focused on curbing excessive credit growth in a 'low for long' interest rate environment…With little sign of inflation…priorities for the central bank were to increase the resilience of the banking system in the event of a downturn and reassess the safety of the buy-to-let lending market".

> "Data dependency is one of those phrases that central bankers utter when they don't want to commit themselves too tightly to a precise forecast or expectation given it is stating the obvious."

In short, more regulatory oversight and fewer imminent rate rises. Despite some of the easier energy price induced inflation comparisons falling away during the second half of the year, another year of no UK interest rate rise is very plausible.

However do not assume that will not mean the economic policy backdrop will not tighten. In the same interview Mr Carney noted that current imbalances in the UK economy included "unsecured credit growth at 8 per cent for consumers…and a further fall in the savings rate to historically low levels". The burden of more regulation from the Bank of England, as well as a government-led austerity drive, provide their own challenges.

KEY TAKEAWAYS:

- The chances of interest rate increases in 2016 by the Bank of England has abated in recent months.
- The Bank of England are guiding towards tighter regulatory oversight.
- Growing fiscal austerity may also reduce the likelihood of imminent material interest rate increases.

Bullish until proven otherwise

Jeffrey Saut, chief investment strategist, equity research, takes a look back to see what 2016 may bring for investors.

Year-end letters are always difficult to write because there is a tendency to discuss the year gone by, or worse, try to predict exactly what will happen in the coming year. As a reminder, pundits didn't predict the Paris terrorist attacks, Russian airliner crash in Egypt, Volkswagen emissions scandal or water on Mars. Still, while there is so much we can't predict, we can share our thoughts based on what we do know.

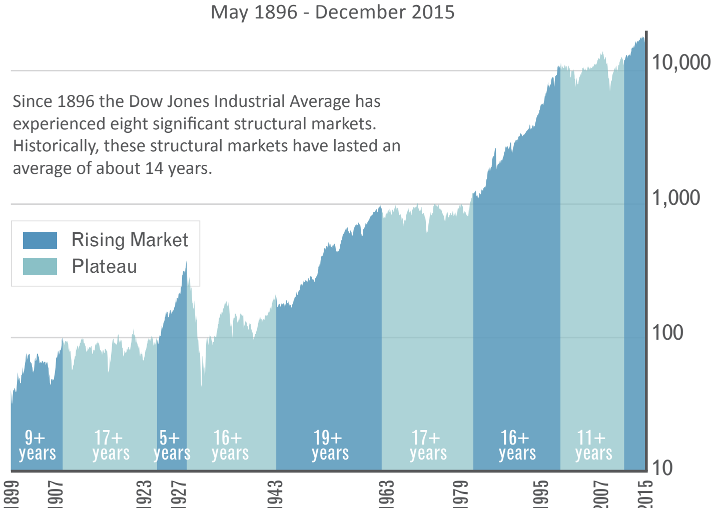
LOOKING BACK: THE YEAR IN REVIEW

So, we began 2015 with advice to investors that if you have stocks in your portfolio that have not rallied in the straight up move since June 2012, without so much as a 10% pull-back, there is likely something wrong and the stock should be sold. Our strategy was to raise some cash because the models/indicators that have worked so well were telegraphing 2015 was going to be sketchy with much more volatility and you would need some cash to take advantage of opportunities as they present themselves. That said, I still thought the S&P 500 would be up by 10.4% for the year. That view was probably my worst "call" of the year.

My best "call" was likely when my models said in early July that the equity markets were going into a period of contraction. Quite frankly, I did not think the contraction would be as deep as it was at 12.4% (based on the S&P 500), but I did say on CNBC at the August "lows" the equity markets were going to bottom that day. Becky Quick responded, "Jeff, NOBODY comes on this show and says the equity markets are going to bottom today," but that is exactly what I said while adding that bottoms tend to be a process and not an event.

DOW JONES INDUSTRIAL AVERAGE – STRUCTURAL MARKETS

May 1896 - December 2015



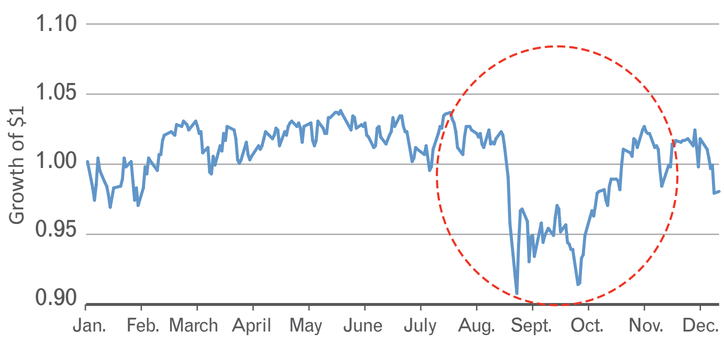
Source: Raymond James Research

This meant that what you tend to get is a "capitulation low" (August 24th), followed by failed rally attempts, and then the market comes back down and tests the "capitulation low," which is precisely what happened in late September. The resulting chart pattern formed a classic "W-shaped" bottom (see chart), or as a technical analyst would term it, "double bottom." Accordingly, we averred the bottom was "in" late in September and the secular bull market was still alive.

Secular bull markets tend to last 14 to 15 years and compound at ~16% per year. So, if past is prelude, we should have another seven to eight years left in this one. The only caveat I would offer is that

CLASSIC W-SHAPED BOTTOM

2015 S&P 500 Daily Returns through 12/14



PAUL TUDOR JONES,
Legendary Investor

"I'm always thinking about losing money as opposed to making money. Don't focus on making money; focus on protecting what you have."

if the August 25th closing "lows" for the Dow Jones Industrial Average and Dow Jones Transportation Average are both violated (the Transports have already done so) I will have to reconsider my bullish stance. For the record, those closing lows are 15666.44 and 7466.97, respectively. We use these levels as a "fail-safe point" because "The essence of portfolio management is the management of 'risks,' not the management of 'returns,'" indeed, investing is all about managing risk! As legendary investor Paul Tudor Jones once said, "I'm always thinking about losing money as opposed to making money. Don't focus on making money; focus on protecting what you have." Obviously, we carry that strategy into 2016.

LOOKING AHEAD: THE OUTLOOK FOR 2016

Speaking to 2016, I predict, as I always do when asked how much the S&P 500 will rise in the new year, a 10.4% return. Why 10.4%? … because since 1921 that has tended to be the average annual return for the S&P 500. Of interest is that roughly 5% of that yearly return comes from earnings growth, 0.9% comes from price/earnings multiple expansions (PE), but a large 4.5% comes from dividends. Verily, dividends play a huge role in the total return of portfolios.

Yet while returns are important, your financial life is more about your long-term goals than it is about yearly returns. To this point, investing is about the "insights," and the screening out of "noise," gleanings you receive from your Raymond James team, as well as the management of "risks." There are three kinds of risk: 1) Personal Risk; 2) Market Risk; 3) Idiosyncratic Risk (specific risk to an asset class like we saw in the upstream MLPs). Hereto, your Raymond James team can help reduce these risks.

Strategically, I think the fundamentals will improve in 2016 for most U.S. equities. International equities need more of a "rifle approach" as there will be various winners and losers. On fixed income, I am circumspect, thinking with interest rates at zero there is only one way for rates to go. I do, however, like alternative investments, but hereto you need a "rifle shot" approach. The U.S. dollar looks higher to me, commodities look lower, Washington, D.C., looks more functional, the Federal Reserve has raised interest rates, but going forward it will be at a very slow pace, corporate tax reform is coming, energy prices are bottoming, inflation should remain contained, and the only sectors I am shy of are utilities and staples.

In conclusion, our 2016 outlook is supportive of equities driven by improving global growth, slowly rising interest rates, a stronger U.S. dollar and low inflation. I expect equities to outperform bonds, commodities and alternative investments. Managing the "risks," and rebalancing portfolios accordingly, should be the key for successful investing in the new year.

KEY TAKEAWAYS:

- Strategically, fundamentals will improve in 2016 for most U.S. equities. International equities need more of a selective approach as there will be various winners and losers.
- Equities are expected to outperform bonds, commodities and alternative investments.
- While returns are important, your financial life is more about your long-term goals than annual performance numbers. To this point, investing should focus on insights, screening out noise and managing three types of risks: personal, market and idiosyncratic (a specific risk to an asset class).

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