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ISSUE 7 // OCTOBER 2016

# INVESTMENT STRATEGY QUARTERLY



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Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your wealth manager to discuss the content of this publication in the context of your own unique circumstances. Published October 2016. Material prepared by Raymond James as a resource for its wealth managers.

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## INVESTMENT STRATEGY QUARTERLY RECAP

Economic and financial market headwinds for the next six to twelve months include earnings growth, Federal Reserve policy, global economic growth, the U.S. presidential election, and geopolitical uncertainty. Top tailwinds include low interest rates and energy prices, strong consumer fundamentals, an improving labour market and a stabilising U.S. dollar.

**U.S. ECONOMY** – **Scott Brown**, Chief Economist, Equity Research

### FEDERAL RESERVE

- In August, Federal Reserve officials, including Chair Janet Yellen, appeared to be setting the stage for a September rate hike. However, since then, many of the economic data releases have been on the soft side of expectations, and the Federal Open Market Committee (FOMC) did not raise the federal funds rate at its September 21 policy meeting.
- In its policy statement, the FOMC noted that while the case for an increase “has strengthened,” the committee “decided, for the time being, to wait for further evidence of continued progress toward its objectives.” Three of the ten FOMC members dissented in favor of an immediate increase. Ten of the 17 senior Fed officials expect to raise rates by the end of this year, but officials also foresaw a lower path of rate hikes in 2017 and 2018 than they did three months earlier.
- “The Fed does not want to shock the financial markets. Raising rates in September would have gone against market expectations. Fed decisions will remain data-dependent, but a December move is more likely than not.”

### BUSINESS VERSUS CONSUMER SPENDING

- “Soft trends continue in business fixed investment worldwide. Manufacturing has been mixed, but generally down slightly or flat. These figures aren’t recessionary, just sluggish.”
- “Consumer fundamentals are still positive at this point. Job growth is healthy, we are seeing moderate wage increases, and gasoline prices are still relatively low. With consumers representing about 70% of the economy, that’s all very helpful.”

### FISCAL POLICY

- “We are seeing greater calls for fiscal stimulus, both in the U.S. and worldwide. Both U.S. presidential candidates have proposed an increase in infrastructure spending. The problem is, it’s not going to be as effective in boosting overall growth as it would have been in the depth of the recession, and federal budget constraints will become more worrisome as the baby-boom generation continues into retirement.”

### U.S. EQUITIES

- “Increased dispersion and lower correlations give you greater alpha opportunity. When stocks are neutrally valued or overvalued, you want active management. The cheap beta trade is over.”

– **Jeff Saut**, Chief Investment Strategist, Equity Research

- “Technical readings are still strong. When the market seems like it should be going down and it just keeps dragging up, it’s usually a good sign. It’s usually a sign that things are a lot better than the market expects.”

– **Andrew Adams**, CMT, Senior Research Associate, Equity Research

### EARNINGS

- “As far as profits go, there was a trough in the fourth quarter of last year. Historically, you typically need a dearth in profits in order to have a recovery.”
- “The markets are transitioning from an interest rate-driven bull market to an earnings-driven bull market.”

– **Jeff Saut**, Chief Investment Strategist, Equity Research

- “If you look back over the last 25 years or so, earnings don’t usually level off and then go back down. Usually you see a sharp decline, they level off and then go back up, which is what it seems we are seeing now. I am in the camp that we have probably seen an earnings trough and things are going to get better.”

– **Andrew Adams**, CMT, Senior Research Associate, Equity Research

- “Companies need to get away from financial engineering and focus on investing shareholder money for long-term competitive advantage and growth, not current yield.”

– **James Camp**, Managing Director of Fixed Income, Eagle Asset Management\*

## 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.

**Andrew Adams, CMT** Senior Research Associate, Equity Research

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

**Scott J. Brown, Ph.D.** Chief Economist, Equity Research

**Robert Burns, CFA, AIF** Vice President, Asset Management Services

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

**Doug Drabik** Senior Strategist, Fixed Income

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

**Nick Goetze** Managing Director, Fixed Income Services

**Peter Greenberger, CFA, CFP** Director, Mutual Fund Research & Marketing

**Nicholas Lacy, CFA** Chief Portfolio Strategist, Asset Management Services

**Pavel Molchanov** Senior Vice President, Energy Analyst, Equity Research

**Kevin Pate, CAIA** Vice President, Asset Management Services

**Paul Puryear** Director, Real Estate Research

**Jeffrey Saut** Chief Investment Strategist, Equity Research

**Scott Stolz, CFP** Senior Vice President, PCG Investment Products

**Benjamin Streed, CFA** Strategist, Fixed Income

**Jennifer Suden, CAIA** Director of Alternative Investments Research

**Tom Thornton, CFA, CIPM** Vice President, Asset Management Services

**Anne B. Platt, AWMA, AIF** – Committee Chair  
Vice President, Investment Strategy & Product Positioning, Wealth, Retirement & Portfolio Solutions

**Kristin Byrnes** – Committee Vice-Chair  
Product Strategy Analyst, Wealth, Retirement & Portfolio Solutions

**EUROPE – Chris Bailey**, European Strategist, Raymond James Euro Equities\*

### EUROPEAN EQUITY

- “We’ve seen a very strong UK stock market – of course the UK stock market and the UK economy are two very different things. The fall of the pound is great for the big dollar earners, Asian earners, etc., which are core participants of the UK stock market.”
- “There have been huge outflows from the pan-European markets (including the UK) over the last few months and this has created value opportunities. That is still apparent.”
- “Earnings are still flat and at very low levels. There is a lot of differentiation at the sector level as well as sector rotation, creating opportunities. Ultimately, I would say my biggest observation would be the effects of the pound since it is now too cheap against the dollar.”

### BREXIT

“As the UK separates from the EU, they have to negotiate with every other country in terms of trade. That’s going to take a lot of time. Brexit is going to create a lot of uncertainty so it’s still viewed negatively, but it’s also pretty far out on the road map.”

– **Scott Brown**, Chief Economist, Equity Research

### BOND MARKETS

- “One of our primary messages is the importance of asset allocation, especially in this market. Stay in the investment-grade space, maybe at the lower end of the credit spectrum. There isn’t enough reward outside of quality fixed income. Avoid short duration and stay in the intermediate part of the curve.”
- **Doug Drabik**, Senior Strategist, Fixed Income

### INTEREST RATES

- “I don’t think long-term rates are going to go meaningfully higher, and I don’t think it’s for the reasons that we want or expect them to. You’ve got money flowing in from overseas at record-breaking numbers. This isn’t stopping anytime soon. It’s going to take a global recalibration, not just in the U.S., for long-term rates to move.”
- **Benjamin Streed**, Strategist, Fixed Income

### MUNICIPALS

- “Municipal credit quality by and large is improving. Upgrades are outpacing downgrades on the ratings front.”
- **James Camp**, Managing Director of Fixed Income, Eagle Asset Management\*

### CORPORATE CREDIT

- “Corporate credit metrics such as leverage and interest coverage have been deteriorating for years at companies engrossed by dividends and buybacks, in some cases very rapidly. We’re at a tipping point with these balance sheets and in a year or two from now things are going to come home to roost. It is unsustainable.”
- **James Camp**, Managing Director of Fixed Income, Eagle Asset Management\*

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

- “Certain corporate credit metrics have been compromised due in part to shareholder rewards such as share buybacks and/or dividends. This practice compels us to promote more discriminatory credit selection within the corporate sector based on more than just yield. In addition to select corporations, the high yield space in general has heightened its leverage and seen deterioration in interest coverage; however, the median nonfinancial investment-grade space has maintained leverage ratios and actually improved interest coverage. Careful selection within the corporate space can provide investors with a needed spread alternative.”

– Doug Drabik, Senior Strategist, Fixed Income

**REAL ESTATE – Paul Puryear, Director of Real Estate Research**

- “The signals that we are getting are that housing is just going to continue to limp along. It’s not robust.”
- “There’s an expectation that the millennials are going to bail us out and start buying houses. 50% have no credit or sub-par credit. So about 40% are subprime, 10% have no credit at all. Those that do have credit, and it’s not a very big number, have used 80% of it on student loans, cars, credit cards, etc. There’s nothing left to buy a house with at this point.”

- “There is an affordability gap for median to lower income home buyers being driven by outsized inflation in the cost to build houses relative to the very slow growth in household income. This inflation is being driven by labour and land costs with little pressure from materials.”
- “This same replacement cost inflation is helping drive rents higher in commercial real estate while the cost of capital, tied to the low ten-year yield, is very favourable. This gap is good news for commercial property owners and REITs but will continue to be a headwind for the U.S. housing market.”

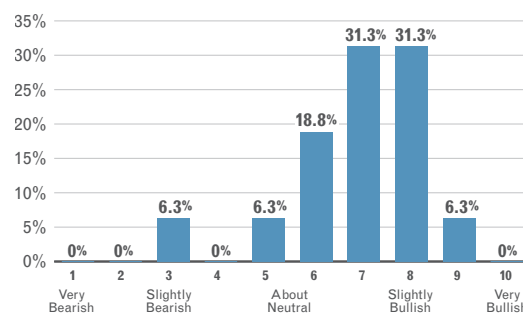
**ALTERNATIVE INVESTMENTS – Jennifer Suden, Director of Alternative Investments Research**

- “Relative to a passive investment in domestic equity markets, many hedge fund strategies have underperformed since 2010. However, it is important to note that many hedge fund strategies are seeking to mitigate downside risk or offer diversification benefits relative to traditional markets, not to necessarily outperform on the upside.”
- “Short selling has been difficult as many stocks have appreciated despite underlying fundamentals. Over the last year and a half, we’ve once again begun to see positive attribution from the short side, with managers seeing a more robust opportunity set on the short side as intra-stock correlations have declined.”

## HIGHLIGHTS FROM THE INVESTMENT STRATEGY COMMITTEE SURVEY

Contrary to past quarters, the committee view on emerging market equities over the next 6-12 months is bullish to some degree. Peter Greenberger explores past challenges and potential opportunities in his article on page 12

**FIGURE ONE: Emerging Equity Market**  
Over the next 6-12 months, my overall outlook for emerging equity markets is:



Source: October 2016, Raymond James Investment Strategy Committee Survey

There is no assurance that any investment strategy will be successful. Investing involves risks including the possible loss of capital. Dividends are not guaranteed and will fluctuate. There is no assurance any of the trends mentioned will continue or forecasts will occur. 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 markets can be riskier than investing in well-established foreign markets. 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. The value of REITs and their ability to distribute income may be adversely affected by several factors, including rising interest rates, changes in the national, state and local economic climate and real-estate conditions, and other factors beyond their control.

## US ECONOMIC SNAPSHOT

Federal Reserve (Fed) officials came close to raising short-term interest rates at the September 20-21 policy meeting, but decided to wait for more evidence. More importantly, officials' expectations of future rate hikes turned shallower. Higher rates, as part of monetary policy normalisation, simply means that the Fed is more confident on the economy. However, a slower trend in population growth and more modest growth in worker productivity implies that trend GDP growth will be a lot slower: 1.5-2.0% vs. the 3.0-3.5% pace from 1960-2000.

**SCOTT BROWN**  
Chief Economist,  
Equity Research

STATUS	ECONOMIC INDICATOR	COMMENTARY
POSITIVE OUTLOOK	GROWTH	The consumer leads the way, and fundamentals remain sound. GDP growth in recent quarters was restrained by slower inventories, but lean inventories pave the way for better production in the future.
	EMPLOYMENT	Nonfarm payrolls have been uneven in recent months. The underlying pace remains strong, but a bit slower than the last two years (partly reflecting tighter labour market conditions).
	CONSUMER SPENDING	Strong job growth and moderate wage gains have been supportive. Low gasoline prices have added to purchasing power, but that effect should fade as oil prices begin to firm.
	HOUSING AND CONSTRUCTION	Higher home prices have added to affordability issues and builders continue to note some supply constraints, but the trends in sales and construction activity are higher.
	MONETARY POLICY	Momentum has clearly been building for a further increase in short-term rates, but the Fed is expected to remove accommodation very gradually.
	FISCAL POLICY	State and local government budgets are in better shape and spending should add to GDP growth (but not by a lot). The federal budget outlook depends on the election outlook.
NEUTRAL OUTLOOK	THE DOLLAR	The dollar is likely to remain range-bound, with gradual Fed tightening already priced in. However, the presidential election will be a factor.
	BUSINESS INVESTMENT	Firms have the ability to boost capital spending, but a soft global economy and election-year uncertainty are constraints. Orders for capital equipment appear to have firmed in recent months.
	MANUFACTURING	Still a mixed bag across industries, but consistent with a slow patch, not an outright recession.
	INFLATION	Little to no inflation in goods. Rents and medical care are rising, but core inflation has remained relatively low.
	LONG-TERM INTEREST RATES	Bond yields remain low worldwide. Slower trend growth in GDP implies that long-term rates are likely to stay low.
	REST OF THE WORLD	The global outlook remains relatively soft by historical standards, with a number of downside risks, but should improve somewhat in 2017.





## Has the UK economy shrugged off the Brexit vote?

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

*"A successful man is one who can lay a firm foundation with the bricks others have thrown at him."*  
David Brinkley

Mark Carney - the Governor of the Bank of England – was in his own words feeling ‘serene’ about both his own performance last month in front of the House of Commons Treasury Select Committee, and the UK economy. Back in August he had authorised - after a vote from the Bank’s Monetary Policy Committee – the first cut in UK interest rates since the depths of the global financial crisis, as well as an extension of the quantitative easing stimulus programme. There had been a common consensus following the Brexit vote in late June that the Bank of England should undertake a clear loosening of policy to guard against any negative economic reaction, but - by the time the actual stimulus policy had been enacted – statistical evidence was starting to mount that the UK economy had not faltered after the Brexit vote.

Fluctuating economic confidence levels, the influence of weather and the anticipation of stimulus policy undoubtedly all played a role in the relatively robust UK economic data released in the period since the Brexit vote. A less charitable view would be that all the UK economy has seen is a ‘phoney war’ period, where little has been decided, but as policy has been loosened and the Pound has fallen, some solidity in economic performance has occurred.

Potentially much darker days lay ahead, however. Estimates for the UK’s economic growth in 2017 have congregated around a clearly below trend 1% level, and all of those carefully calibrated Brexit impact economic models are still lingering in the background, waiting for

Estimates for the UK’s economic growth in 2017 have congregated around a clearly below trend 1% level

WORLD ECONOMIC OUTLOOK	
	2017 estimated economic growth
UK	1.10%
US	2.20%
Euro area	1.50%
Japan	0.60%
Canada	1.90%
China	6.20%

Source: IMF

challenges in implementing the UK’s new trade policies with countries not just in the European Union, but around the whole world.

The key is the treatment of goods, services and factors of production, like labour and capital. Whilst existing international regulation, put together by bodies like the World Trade Organisation, provide a solution, it is necessarily a retrograde step as tariff barriers would be reintroduced on even the most basic imports into the UK – and quite conceivably in reaction to this on our own exports too.

As has been apparent in general global trade policy over the last decade, protectionist pressures are bubbling up again, as evidenced by the rhetoric from both main US Presidential candidates and the popular disdain towards further transatlantic trade liberalisation in Germany. The UK may have a timetable for the implementation of the start of the divorce proceedings with the European Union (Article 50) by the end of March 2017, but with the formal exit likely to take up to a further two years, uncertainty will remain. And for important industrial sectors within the UK economy - such as financial services - an inability to potentially transact region-wide business due to a lack of continuing passporting accreditations is an obvious concern.



With other countries – both in the continuing European Union and potentially in the wider world – looking to take advantage of any change in the UK's competitive positioning, a variety of challenges remain which are hard to fully anticipate.

If I have learnt anything about economics over the last twenty years, it is that you will get a range of different opinions from a range of different economists... and one set of economic criteria or policies generally do not work everywhere. Often, the political and social shifting sands change views and opinions over time.

What matters more than anything in an uncertain environment is 'buy in'. The day American citizens do not believe they can become rich or become President, will be the day the amazing economic performance of the United States comes to an end. Similarly, the vision that the average Swiss, Singaporean, Swedish or Dutch citizen has about their country's general direction and values – which all subtly differ from one another. After such a split Brexit vote, this 'vision thing' is the key for UK policy makers – and the key is that it has little to do with being in the European Union or not.

The UK is a very international economy, and UK corporates have no choice but to be competitive with all types of economies around the world – either compete or commercially die. So no 'little Englander' tariff barriers and defensive postures.

Often, the political and social shifting sands change views and opinions over time

In short, if the UK wants to stay wealthy and shrug off any negatives from exiting the European Union, then the country has to embrace the world – as an individual, investor, employee or entrepreneur. And if we all do this, then the UK's economic outlook will take care of itself. If not, then the spectre of uncertainty will linger at a clear cost for everyone. ■

If the UK wants to stay wealthy and shrug off any negatives from exiting the European Union, then the country has to embrace the world

#### KEY TAKEAWAYS:

- The UK economy has seen a 'phoney war' period where little has been decided
- The UK may have a timetable for the implementation of the start of the divorce proceedings with the European Union, but up to a further two years' uncertainty will remain
- The UK is a very international economy and UK corporates have no choice but to be competitive
- If the UK wants to stay wealthy it has to embrace the world

# After FTSE 7000 can there still be a Santa rally?

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

*"There are over 7,000 different types of proteins in typical eukaryotic cells; the total number depends on the cell class and function." Ada Yonath*

It is amazing what you can find on the internet about the number 7,000. I could say the same about the UK's premier large cap share price index bursting through this round number level on the second business day of October, but of course this achievement has two caveats. First, we have been here before (in 2015) and second, the role of the falling Pound should not be underestimated, as a quick look at the same index in dollar or euro terms shows.

Of course, this is the whole point. The UK stock market is not the UK economy and with well over two-thirds of UK listed company corporate earnings being generated in the Americas, Asia, Continental Europe or the emerging markets, such a move is to be expected, as translated back into Sterling, profit flows are more valuable. Additionally, you may also get an export capability boost for some companies too, but I think this is a secondary effect.

The cumulative stock market performance excitement of the last three months has come at an unusual time of year, versus typical seasonal UK equity market performance cycles, which show the first and last quarters of the year as being the best performers. So, has the weak Pound induced post Brexit vote UK market boost stymied any hopes of a typical 'Santa rally'?

Given the above, the first question has to be whether the Pound will fall further, potentially creating the conditions for a further UK stock market performance virtuous cycle. Working out longer term currency

The UK stock market is not the UK economy

FAIR VALUE OF VARIOUS CURRENCIES VERSUS 1 US DOLLAR		
UK	£	1.443
Euro area	Euro	1.304
European Union	Euro	1.312
Switzerland	CHF	1.275
Japan	Yen	105.332

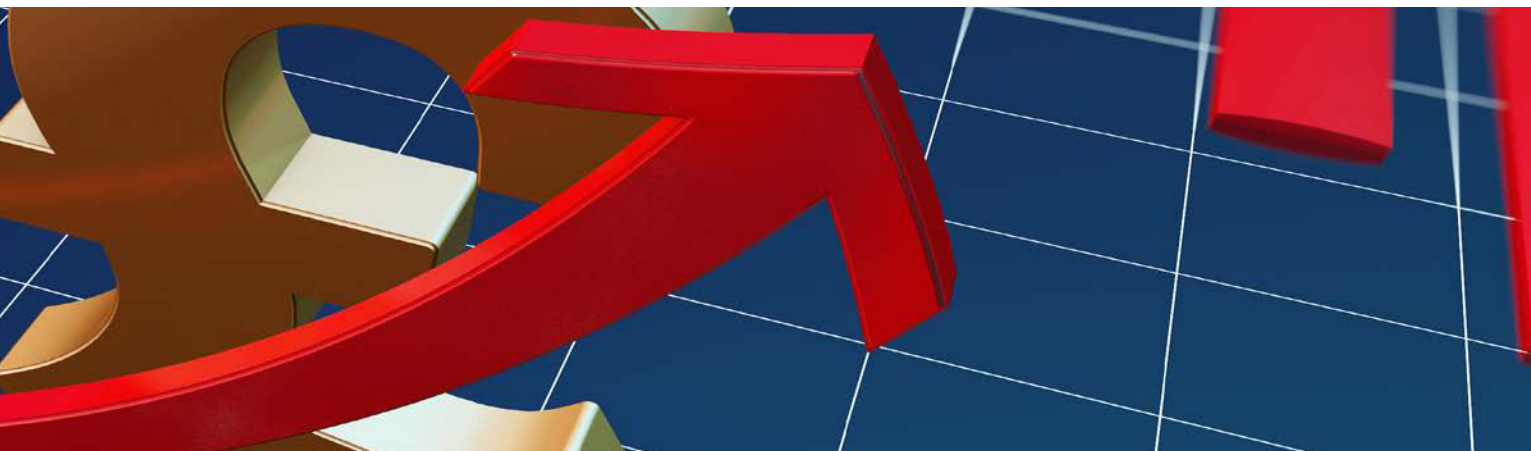
Source: Purchasing Power Parity data via the OECD as at 05/10/16

values is necessarily an imprecise science, however purchasing power parity (PPP) models do typically suggest that a rate of around 1.50 against the US dollar – ironically the prevailing level just prior to the declaration of the Brexit vote – was approximately correct. With the Pound currently scuttling around at a thirty one year low versus the US currency, at an exchange rate below 1.30, the British currency looks cheap.

Of course, many factors can influence currency value. The forward profile for UK growth, as suggested by Bank of England or City forecasts, suggests 2017 will be a year of clearly below trend economic performance. Mix in the recent catalyst – which undoubtedly has been shorter term influential on the Pound – of a clarification of the timing of the imposition of the Article 50 European Union 'divorce' timetable, and criterion for a sustained weakness of the Pound could be apparent.

Thirty one years is a long time at many levels including in the world of currencies. Back in 1985 there was talk of parity between the US dollar and the Pound. This never occurred – and ultimately the Pound bought





more than two dollars. I have similar feelings today. Uncertainties around the post-Brexit UK economy is a known unknown, and appropriately a clear discount to PPP currently exists. Positioning data shows that professional speculator holdings of the Pound are near record low levels, strengthening the feeling that a high level of pessimism is already baked in.

So if the Pound is unlikely to weaken noticeably further – and indeed I believe is likely to have ground higher against the dollar and euro over the balance of the year from prevailing levels – what catalysts are left for the UK equity market above the 7,000 index level? Clearly, a successful Autumn Statement by the Chancellor of the Exchequer could boost confidence that government fiscal policy can be stimulatory. Similarly, further policy loosening by the Bank of England could be applied. Neither mechanism strikes me as deeply influential however, for the balance of 2016. Similarly, the Article 50 imposition and Brexit negotiations are more a 2017-18 matter. We are likely to be stuck with a feeling of policy uncertainty for the balance of 2016.

Aside from the still attractive scope for mis-pricing in individual equities, and selected out of favour sectors allowing 'mix' to provide a positive backdrop for active stock selectors to generate good outperformance, I think it is unlikely the leading larger cap UK market pushes decidedly above the 7,000 point index level during the balance of 2016. In short, the weakness in the Pound has helped pull forward the Santa rally.

For UK investors, Christmas has come early. At least there are still a few presents to unwrap for stock pickers. Or, as investment parlance would put it: 'invest in alpha not beta in the UK market for the rest of 2016' ■

The forward profile for UK growth, as suggested by Bank of England or City forecasts, suggests 2017 will be a year of clearly below trend economic performance

#### KEY TAKEAWAYS:

- We have seen FTSE 7000 before (in 2015) and the role of the falling Pound should not be underestimated
- Stock market performance excitement of the last three months has come at an unusual time of year versus typical seasonal UK equity market performance cycles
- Positioning data shows that professional speculator holdings of the Pound are near record low levels, strengthening the feeling that a high level of pessimism is already baked in
- Unlikely the leading larger cap UK market pushes decidedly above the 7,000 point index level this year
- For UK investors, Christmas has come early; at least there are still a few presents to unwrap for stock pickers

# Earnings: The Lifeblood of the Market

**J. Michael Gibbs**, *Managing Director of Equity Portfolio & Technical Strategy*, and **Joey Madere**, *Senior Portfolio Analyst, Equity Portfolio & Technical Strategy*, explain the importance of earnings while examining past, current and future earnings estimates.

Over the long term, earnings are the lifeblood of the stock market. They are the reason investors buy equities – having confidence that these companies will continuously earn profits and those profits will ultimately flow back to shareholders. Earnings and their projections are vital to investors, as they assess their willingness to commit to an ownership stake going forward.

## A HISTORICAL PERSPECTIVE

Following the credit crisis in March 2009, the Federal Reserve (Fed) began stimulating the U.S. economy through its quantitative easing (QE) programs. This had a positive effect on earnings, as consumer spending was encouraged and interest rates were pushed down resulting in cheaper costs for borrowing and investment.

However, in October 2014, the Fed announced the end of its latest QE program and, subsequently, earnings slowed. While all of the blame can't be placed on the completion of the bond-buying program, in our opinion, it did play an indirect role. Due to the anticipation of higher interest rates, the U.S. dollar strengthened considerably creating a major headwind for U.S. multinational corporations that receive significant profits in foreign currencies. At the same time, crude oil prices collapsed, putting immense pressure on commodity-exporting emerging markets, as well as the energy, materials and industrials sectors. As a result, S&P 500 earnings and the stock market stalled.

## THE CURRENT ENVIRONMENT

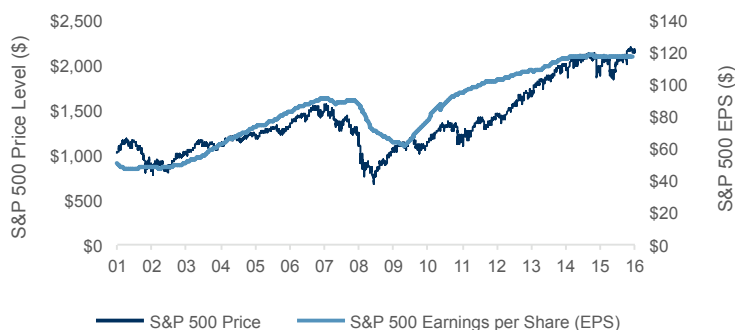
Recently, the S&P 500 broke out of its near two-year trading range to all-time highs. Contributing to this rebound were reduced fears of slowing global growth, particularly in China, optimism about the U.S. economy, and the expectation for S&P 500 earnings to recover moving into 2017. Likewise, recent pressures should abate as energy prices continue to recover and the U.S. dollar remains stable as of late September. The industrial side of the economy is also showing signs of improvement.

Although it is possible for the stock market to move higher absent earnings growth, certain conditions need to be in place to foster further appreciation. In the few instances that this occurred, the late '50s and late '80s, valuations were much lower than they currently are. The combination of price-to-earnings expansion and optimism that earnings would soon pick up added fuel to market gains. With the S&P 500 trading at elevated valuation levels, investor optimism over earnings expectations is vital for the current market to move appreciably higher.

## HOW ARE EARNINGS ESTIMATED?

Consensus earnings estimates are aggregated using two variations of forecasting. Top-down strategists start from a macro perspective – estimating economic growth, sales growth and margins on a sector level – using historical and current trends in order to come up with earnings estimates. On the flip side, bottom-up analyst estimates are aggregated using the consensus earnings estimates for each individual stock within the S&P 500. Historically, it has been common for top-down strategists' estimates to be a little more conservative, and more accurate, than the bottom-up analyst estimates when forecasting S&P 500 earnings.

**S&P 500 PRICE LEVEL VS. EARNINGS PER SHARE**



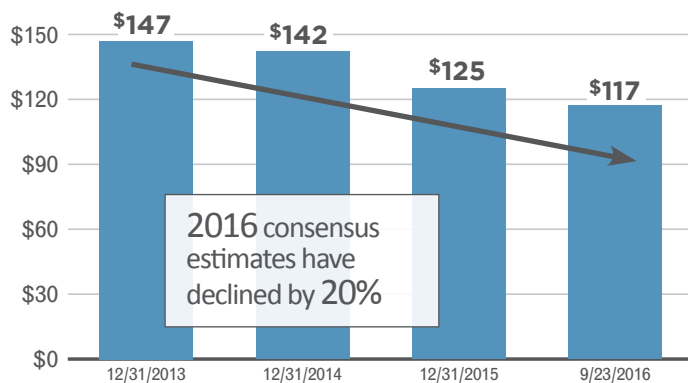


Since the end of the credit crisis, initial bottom-up earnings estimates have consistently been high followed by downward revisions. For example, 2016 estimates were initially \$147 at the end of 2013 and are currently \$117. This is approximately 20% lower than the first estimate, and far from the 13% average reduction in estimates since 2009. Similarly, 2013 - 2015 estimates were revised downward by 14%, 11% and 13%, respectively.

In order for our estimates of 2% earnings growth to be met in 2016, stabilisation of the U.S. dollar and oil prices, as well as improvement in consumer spending and the industrial side of the economy, will have to continue. Furthermore, global macroeconomic shocks and potential Fed activity will likely have to remain muted.

While 2017 earnings and profit margin growth-rate estimates are possible, we believe they are far too optimistic when calculating a base-case scenario. With interest rates potentially ticking higher at some point, debt will become more expensive. Share buybacks, which have been robust in recent years and have helped earnings artificially grow, will likely subside as well.

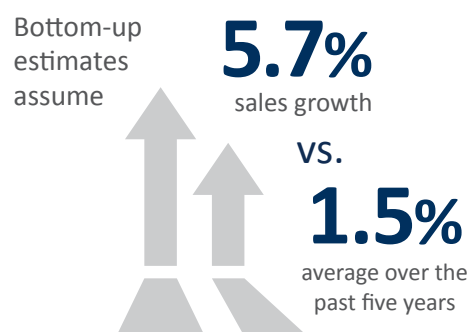
**2016 CONSENSUS BOTTOM-UP  
EARNINGS ESTIMATES**



Source: Factset

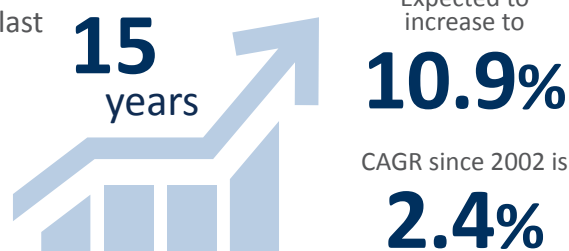
**CONSENSUS BOTTOM-UP ESTIMATED  
EARNINGS: \$133**

**2017 EST. SALES GROWTH**



**2017 EST. PROFIT MARGIN GROWTH**

2017 profit margins growth rate highest increase in last



Source: Factset

**RAYMOND JAMES ESTIMATED EARNINGS: \$128**

Assuming a sales increase of **5%** and with margins expanding by **3.5%** versus 2016 estimates.

Representing **7.6%** earnings growth, **\$128** is slightly above the S&P 500 earnings **6.0%** compounded annual growth rate since 1954.



# Earnings: The Lifeblood of the Market

With the S&P 500 at above-average valuations and lofty, according to some metrics, earnings growth will likely have to resume higher in order to justify appreciably higher prices for this market over the next 12 - 18 months. For now, it appears that economic activity and earnings should pick up toward the end of 2016 and into 2017. If this comes to fruition, the current bull market could continue into 2017.

## KEY TAKEAWAYS:

- Earnings are the lifeblood of the market as they assess the willingness of market participants to invest over future periods.
- With the S&P 500 at above-average valuations, earnings growth will likely have to resume higher to justify appreciably higher prices for the S&P 500 over the next 12-18 months.
- It appears that economic activity and earnings should pick up into the end of 2016 and into 2017.

## UNDERSTANDING PRICE-TO-EARNINGS

To calculate potential S&P 500 prices for the next 12-18 months, price-to-earnings multiples (P/E multiples) are applied to earnings estimates.

### WHAT IS A P/E MULTIPLE?

The price-to-earnings ratio, or multiple, measures how expensive a stock is. In other words, it values a company by looking at the current share price relative to its per-share earnings. Generally, the larger the multiple, the more “expensive” the stock is, meaning that investors are paying more for each dollar of earnings versus a stock with a lower multiple.

### WHAT IS P/E MULTIPLE EXPANSION?

Multiple expansion occurs when the P/E ratio rises due to an increase in the stock price with no change to earnings. Essentially, the increase in the P/E is not a result of any fundamental improvement in the company, but rather reflects expectations of future growth.

### HOW DO P/E MULTIPLES APPLY TO THE

	Today	In 6 months
EARNINGS PER SHARE	\$2	→ \$2
PRICE/EARNINGS	10	→ 15
STOCK PRICE	\$20	→ \$30

## CURRENT ENVIRONMENT?

Given global challenges to economic growth, we find it difficult to justify a P/E multiple beyond 18x trailing earnings as our base case (current P/E is ~18.5x). An S&P 500 level near 2,300 is produced at 18x potential earnings of \$128.

In a bull-case scenario, given the current low inflationary - and low interest-rate environment, a slightly higher market multiple can be envisioned in a “Goldilocks outcome” for global growth. In such a case, we apply a P/E of 19x to the \$128 of earnings to produce a bullish price potential of approximately 2,340 for the S&P 500. If earnings fail to rebound, the odds are high that the current market multiple will contract, resulting in slightly lower prices for the S&P 500 from current levels.

Past performance may not be indicative of future results. Investing involves risk including the possible loss of capital. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. 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. There are additional risks associated with investing in an individual sector, including limited diversification. There is no assurance that any estimate will be accurate.





**Peter Greenberger, CFA, CFP®,** Director of Mutual Fund Research & Marketing, and **Matt Feddersen,** Mutual Fund Analyst, outline how stabilising headwinds and attractive valuations may provide investment potential in these beaten-down markets.

Over the last several years, emerging markets have faced a challenging investment environment leading many market participants to reduce or completely eliminate exposure to these equities. Slowing global growth, particularly in China, has been a powerful headwind as this leading importer of commodities-based emerging economies dropped from double-digit economic growth to the 6 - 7% range. Adding to the drag are additional setbacks including geopolitical risk, a strong U.S. dollar, and an abundance of unemployed youth.

#### A DECADE-LONG COMPARISON: EMERGING MARKET AND U.S. EQUITIES

It should come as little surprise that the MSCI Emerging Market Index has lagged U.S. equities since late 2013.



Source: Morningstar Direct and Raymond James. Data shows trailing 10-year returns

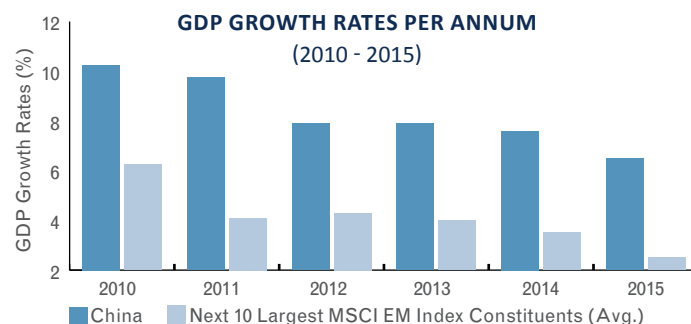
Prior to the late-2014 downturn, when the MSCI Emerging Markets Index (MSCI EM) dropped 35% peak-to-trough, emerging markets were viewed as a source of great potential growth, with a rising middle class, a large youth cohort eager to be educated and employed, and the hope for improved infrastructure and manufacturing. These markets even fared well during the risk-off trading spree following the financial crisis of 2008, with part of this resilience attributed to these markets' lack of involvement in the sub-prime loan business.

#### MOUNTING CHALLENGES

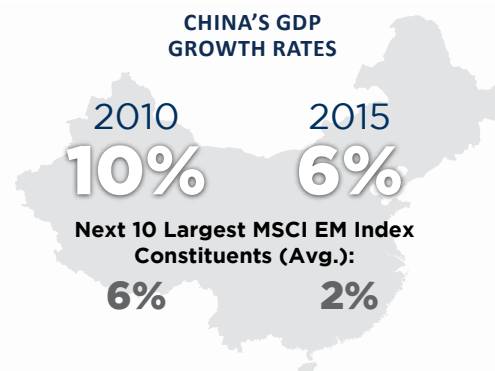
##### CHINA

While challenges are country-specific within this asset class, a shared concern has been the impact of China's slowing economy on the rest of the world. China's transition from an infrastructure- and trade-fueled economy to one driven by domestic consumption has been turbulent, to say the least, as investors anxiously watched to see if the government could manage a "soft landing."

In terms of 2015 GDP figures, China's \$10.9 trillion remains greater than the next ten largest MSCI EM constituent countries combined. Due to its significant position within the index and investor's immense focus on GDP growth, China has rightly – or wrongly – become the target for investor sentiment concerning all emerging markets.



Source: World Bank as of December 31, 2015





# Emerging Markets: A Re-emergence?

## COMMODITIES AND CURRENCIES

The U.S. dollar has been trending upward since the financial crisis, impeding the returns of foreign investments. A stronger dollar makes it more difficult to pay off U.S. dollar-denominated debt, a major deterrent for those companies that borrowed extensively in this space. Diminished returns from currency fluctuations turned investor interest to other asset classes such as alternative investments and domestic strategies.

Weakened demand for commodities, especially over the last couple of years, further pressures emerging-market growth for those countries whose primary source of trade is commodities based. Simply put, investors still tend to view all emerging market countries in the same light with common economic characteristics such as a direct link to the demand for industrial goods and commodities. The reluctance to examine each country's unique prospects and challenges can lead to overlooked investment opportunities and the potential for sub-par performance.

## EMERGING OPPORTUNITIES

### DEMOGRAPHIC SHIFTS

Many developed nations, such as Japan, Western Europe and the United States, have aging populations that will likely consume less but require more services such as healthcare and assisted living. To the contrary, the European Central Bank estimated that over 80% of the world's population currently resides in emerging market countries, and many of these countries are more heavily skewed toward younger populations.

The transition of these economies from low-wage to a middle-income lifestyles is not only changing the way companies position their products but also who they are selling those products to. Populations in countries like China and India are moving toward middle-income jobs where the consumer will eventually spend more of their disposable income on products and services.

It's not too far of a stretch to assume other emerging markets will follow suit and this demographic shift could be a meaningful source

A recent study by the McKinsey Global Institute titled *Urban World: The global consumers to watch*, noted that:

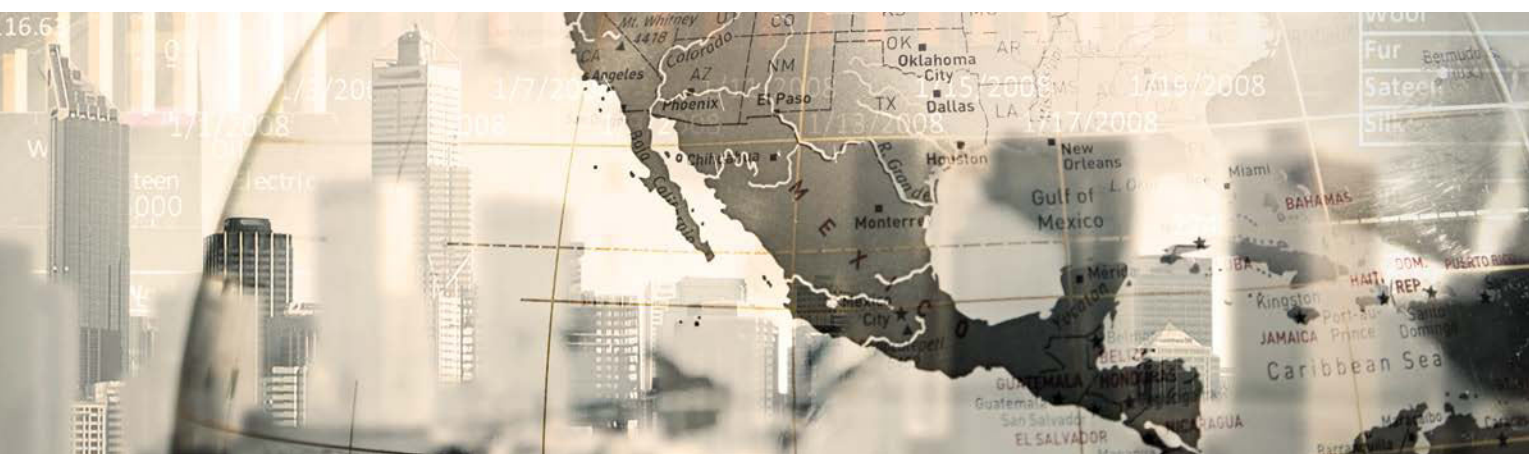
"By 2030, China's working-age population will account for 12 cents of every dollar spent in cities worldwide. This group has the potential to reshape global consumption just as the West's baby boomers, the richest generation in history, did in their prime years."

of global growth going forward.

### TIME TO BUY?

Currently, emerging market equities are attractively valued but this hasn't always been the case. Just prior to, and immediately following the global financial crisis, the MSCI EM's price-to-earnings ratio (P/E) was trending above its long-term average as well as the S&P 500's long-term average. Since mid-2013, this trend has reversed and the P/E for emerging markets has fallen below the S&P 500, implying that these equities are relatively inexpensive, not only when compared to the asset class' historical average, but to U.S. equities as well.

While the case could be made that emerging-market equities are currently inexpensive due to the fact that some of the largest companies in the index are beaten-down commodity producers and partially state-owned enterprises, the fact that this market remains relatively inexpensive continues to be compelling.



### PRICE-TO-EARNING COMPARISON (SEPTEMBER 2006 - AUGUST 2016)



Source: Bloomberg L.P. and Raymond James. All data as of August 31, 2016

China's recent economic growth rate, while significantly lower than past years, appears to be stabilizing and is still over five times higher than U.S. growth. This suggests that the economic transition is likely being managed successfully with a soft landing in the 6 - 7% growth range.

As it pertains to other parts of the emerging markets universe, an argument could be made that Brazil is in the very early stages of stabilization with the recent appointment of a more economically-focused president. In addition, political tensions between Russia and the Western world have tempered, reducing some geopolitical strain for now.

#### WHAT DOES IT ALL MEAN?

As much as emerging markets have been shunned over the last few years, things are looking brighter as major headwinds surrounding economic growth, commodity prices and political instability continue to ease. Layer on discounted equity prices and long-term projected economic growth trends, and now may be an opportune time for this exposure to re-emerge in portfolio allocations. ■

#### KEY TAKEAWAYS:

- Emerging markets faced a challenging investment environment over the last several years leading many investors to reduce or completely eliminate equity exposure to these areas.
- Headwinds include slowing global growth, particularly in China, geopolitical risk, a strong U.S. dollar, and an abundance of uneducated and unemployable youth.
- Conditions are looking brighter as major headwinds are stabilizing. Discounted equity prices and long-term projected economic growth trends may make this an opportune time for this exposure to re-emerge in portfolios.

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# Is the European Union now unsustainable?

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

*"Civilized society is perpetually menaced with disintegration through this primary hostility of men towards one another." Sigmund Freud*

The world's most respected monthly fund management survey has a regular question they pose to survey respondents, asking them to cite their biggest risk concern in today's financial markets. In the last survey the biggest risk concern was 'European Union disintegration'.

Clearly there is a big concern and the confluence of the UK's Brexit vote, political angst directed against incumbent governing parties, persistent high regional unemployment and low growth and general mistrust between continuing European Union members has created the biggest crisis in the European Union's history.

With confirmation that 'Brexit will mean Brexit' by the UK government, the European Union knows that in all likelihood, by the end of this decade, its ranks will no longer include a large, generally quite dynamic economy who is also a net budget contributor.

So can the European Union survive? Brexit has not yet been a galvanizing moment for the continuing members; as many ardent Europhiles would have hoped. Clearly, serious negotiations around Brexit have not yet commenced, but the lack of even tentative forward plans (on both sides) is noteworthy.

From a European Union perspective, a feeling that the practical political equivalent of an ostrich sticking its head in the sand is hard to shake off. However, dig a little deeper and an alternative story starts to emerge.

We all remember the election of the radical, anti-euro, anti-EU, anti-austerity Syriza party in Greece just over eighteen months ago. Those with longer memories will recall the 'Club Med' post global financial crisis concerns as large swathes of southern Europe (and Ireland) struggled. Others focusing more on central banks will note the very vocal disagreements about European Central Bank and whether interest rates should be cut, or quantitative easing measures implemented. At some level, all of these crises have evolved without

yet creating the hammer blow for the European Union, or euro projects a certain fraction of journalist endeavours at the time predicted.

There may be unparalleled levels of distrust, but cut open the average Continental European citizen, and there is on average an instinctively European heart beating inside. Memories of terrible wars and mutual destructions – which in the 1920s and 1930s coloured comments like Freud's above – are a past not to return to, and a rationale for greater regional integration that an island state like the UK was always likely to feel uncomfortable with.

Change has to happen in Europe, however. There is only so far the electorates can be pushed, and with important plebiscites in Italy (in December) on constitutional reform, and in France and Germany (during 2017), plus continuing efforts to elect a sustainable majority government in Spain after two inconclusive elections, there are plenty of ways the ballot box can be used to give incumbent, mainstream politicians a bloody nose. However, at least at this moment in time, this has not created a backdrop where countries are compelled to follow the UK out of the EU bloc – even Greece is implementing structural reforms to gain credit and monies from Brussels and supra-national institutions like the International Monetary Fund.

Structural reforms that boost flexibility, productivity and general competitiveness remain critical, as does the pivotal role of Germany – the European Union's best financed, largest and most influential country. The German Chancellor, Angela Merkel, continues to face domestic political pressure herself ahead of next year's general election, with much of the opprobrium centred on the cost and disruption of her embracing of over a million migrants during the last year or so – a policy which potentially could provide material benefits to the German economy over time in terms of relatively youthful, motivated workers.

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





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In short, it is the tactics and not the strategy or rationale of the European Union which is causing the real problems across Continental Europe. A bout of job creation and real wage growth would do wonders for morale. Ironically, the time it took to agree to European Central Bank stimulus action has meant a lagged beneficial impact, which has lifted European economic growth versus a year or two ago. Problems – such as the Italian banks – still remain, but recent history has suggested that when it is “backs to the wall” decision time, European Union members start to come together. You can imagine last minute communiques and decisions being central to the Brexit negotiations.

Charismatic politicians with populist promises will continue to grab headlines in Europe, but to conclude; how a Germany, France, Italy or Spain will be ruled in such a matter currently remains a stretch. Of course the United States could lead the way on this front... but in Continental Europe the evidence of Greece is that such individuals or

political parties end up retaining the core European Union nomenclature.

The European Union may be losing a key member but, as a regional bloc, do not write it off yet. Historically deep ties, a slightly better economic growth backdrop and a growing realisation that a more coherent use of fiscal redistribution policies from the centre makes considerable sense.

The European Union remains poorly, but at least knows it has to get out of bed. ■

#### KEY TAKEAWAYS:

- A confluence of factors have created the biggest crisis in the European Union's history
- There may be unparalleled levels of distrust but, cut open the average Continental European citizen, and there is on average an instinctively European heart beating inside
- A bout of job creation and real wage growth would do wonders for morale
- The European Union may be losing a key member but, as a regional bloc, do not write it off yet

#### KEY FUTURE POLITICAL DATES

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4 December 2016	-	Italian constitutional referendum
15 March 2017	-	Dutch General election
23 April 2017	-	French Presidential election - first round
7 May 2017	-	French Presidential election - second round
Late September 2017	-	German Chancellor and legislative election

Source: Wikipedia

# Q&A

## Fixed Income: New Norms, Negative Rates and Nonstop Demand

**Benjamin Streed, CFA, Fixed Income Strategist,** addresses common questions and timely concerns regarding the current interest-rate environment.

### Q. REGARDING POLICY “NORMALIZATION,” WHAT ARE NORMAL INTEREST-RATE LEVELS IN THE CURRENT ENVIRONMENT?

**A.** Wherever the “normal” level is for interest rates, it’s very possible it won’t be as high as in past decades. Many of us are mentally anchored to historical interest rates, expecting to one day return to the high nominal yields of the past. Interestingly enough, a “new normal,” or recalibration of interest rates, may be happening right before our eyes.

The Federal Reserve (Fed) noted that over the past 30 years there has been a steep decline in the so-called natural real rate of interest (NRR), which is the equilibrium level for interest rates that puts the economy in neutral gear. Specifically, in the 1980s the NRR was in the range of 2.5 - 3.5% for the world’s major economies, dropping to 2.0 - 2.5% by 1990. Continuing the lower trend, the NRR currently sits at or near historic lows with Canada and the UK, the U.S., and the euro zone at approximately 1.5%, zero, and below zero, respectively.

According to the International Monetary Fund (IMF), this decline is the result of many global economic factors including aging demographics, slower productivity growth and a general global savings glut.

The key takeaway from the Fed’s analysis is that global interest rates could stay lower for longer, not necessarily zero, but certainly lower than historical norms.

### Q. WHO’S BUYING NEGATIVE INTEREST-RATE BONDS AND WHY?

**A.** With an estimated 30% of the global government-bond market trading at negative yields, negative interest-rate bonds are always a topic that makes U.S.-based investors scratch their heads. Many investors view these bonds as a sure-fire way to guarantee a loss, but there’s more to the story than meets the eye. Broadly speaking, three groups of investors engage in this market.

#### INSTITUTIONAL INVESTORS

Institutional investors may actually be required to buy government bonds regardless of their stated yield. Central banks and insurance companies need to meet reserve requirements, pension funds need to match liabilities, index funds must mirror the universe of available bonds, and even traditional banks need to fulfill liquidity requirements and collateral.

#### TRADERS

Some traders either hope to sell these bonds to another investor at an even lower yield, or make a currency play on a foreign currency-denominated bond. For example, a U.S. investor might buy a negative-yielding German bond, or bund, in hopes of the euro appreciating relative to the U.S. dollar. A large enough gain in the euro would offset the negative yield of the bond resulting in a profit.

#### RISK-AVERSE INVESTORS

Simply looking for a “return of principal” rather than a “return on principal,” these investors may choose to trade on the fear that these bonds are “better than cash.” Risk-averse investors can include institutions that have large funds, which make it difficult to move in and out of the markets, that require liquidity and safety above all else, or are unwilling or unable to take on credit risk. Additionally, any investor who believes inflation is likely to turn negative, known as deflation, could see value in a bond with a slightly negative yield, as deflation could turn the real return of the



bond\* positive if inflation meaningfully declines. Finally, some rates on cash savings are more negative than buying bonds so finding a high-quality, liquid bond with a less-negative yield holds some allure.

**Q. WITH RECORD-BREAKING GLOBAL STIMULUS AND ENDLESS DEMAND FOR U.S BONDS, IS THE FEDERAL RESERVE'S TOOLKIT EMPTY WHEN IT COMES TO STIMULATING INTEREST RATES?**

**A.** To put it bluntly, no. Although Fed Chair Janet Yellen noted that the Federal Reserve's pre-crisis toolkit was "inadequate to address the range of economic circumstances," the Fed currently has many options should it find itself in the position to provide further monetary stimulus. The Fed has evolved with expanded stimulus measures including paying interest on excess reserves, conducting large-scale asset purchases known as quantitative easing, and providing explicit forward guidance and communication to the marketplace. These have all been used as additional stimulus tools after short-term interest rates fell to nearly zero in late 2015. Unless a recession is unusually severe and/or persistent, the Fed has stated its belief that a combination of current policy tools would be effective if needed.

Going forward, the central bank has indicated a number of additional monetary policy tools it could use including broader asset purchases, a more flexible inflation target beyond 2%, and even pursuing a nominal level of GDP growth as a stated goal. Additionally, the Fed has commented that future economic duress may be better alleviated through swift fiscal policy response.

One final thought: The Fed has encouraged policymakers/legislators to seek ways through fiscal policy to increase productivity growth, thereby raising the natural level of interest rates and giving the central banks more monetary policy "wiggle room" in the event of a recession. ■

**KEY TAKEAWAYS:**

- Wherever the "normal" level for interest rates is, it's very possible it won't be as high as it was in past decades.
- This decline in rates is the result of many global economic factors including aging demographics, slower productivity growth and a general global savings glut.
- The Fed has encouraged policymakers to seek ways to increase productivity growth, thereby raising the natural level of interest rates and giving the central banks more monetary policy "wiggle room" in the event of a recession.
- Broadly speaking, there are three groups of investors that engage in negative yielding bonds: institutional investors, traders and risk-averse investors.

\*Real return is nominal return less inflation.

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