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INVESTMENT STRATEGY QUARTERLY

TRADE WARS: SHOULD YOU PICK A SIDE?

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Trade Wars: Should You Pick a Side?

Chris Bailey, *European Strategist, Raymond James Euro Equities*,* looks at the options facing investors as the trade war between the U.S. and China heats up.

"Just remember, once you're over the hill you begin to pick up speed" Arthur Schopenhauer

For a number of months now, the world's largest survey of fund managers has observed that, when asked for their greatest financial market fear, the most cited response has been a 'trade war'. There is a significant slug of rationality for this.

GLOBAL GROWTH RISK?

The World Bank has noted that over the 2017-19 period the predicted proportional contribution to global real gross domestic product stands at 35.2% from China and 17.9% from the United States. Unsurprisingly, rhetorical flourishes that have spilled over into heightened, new tariffs, between two countries that currently directly account for over 50% of global growth at-the-margin (and a likely even higher proportion indirectly), have induced concern. So, has the time come for investors to pick a side? When looking to invest outside of the UK, or even into London-listed companies that trade heavily with either nation - should investors be picking a favourite, ignoring the tension or avoiding all impact as much as possible?

WEIGHING UP THE OPTIONS

It does not take much analysis to conclude that trying to avoid all impact is not really an option at all. Concerns about the impact on risk assets from a trade war may push an investor into more fixed income or cash biased investments. However, all investment choices have a trade-off and the current low yielding nature of such investments does not provide much compensation, especially at a time of global inflation bubbling up and a global shift from quantitative easing to quantitative tightening, which could independently prove troublesome for such assets. Additionally, the reliance of many countries on significant non-domestic flows to support their budget deficit and national debt funding operations opens up the potential for surprising trade war impacts, even beyond the trickle-down impact of more uncertain future economic growth rates. Similar unanticipated tactical impacts can easily afflict alternative investments, property and even gold (admittedly of all the above assets have seen this and far more and still persisted but can still be subject to more tactical bouts of underperformance).

> The reliance of many countries on significant non-domestic flows to support their budget deficit and national debt funding operations opens up the potential for surprising trade war impacts

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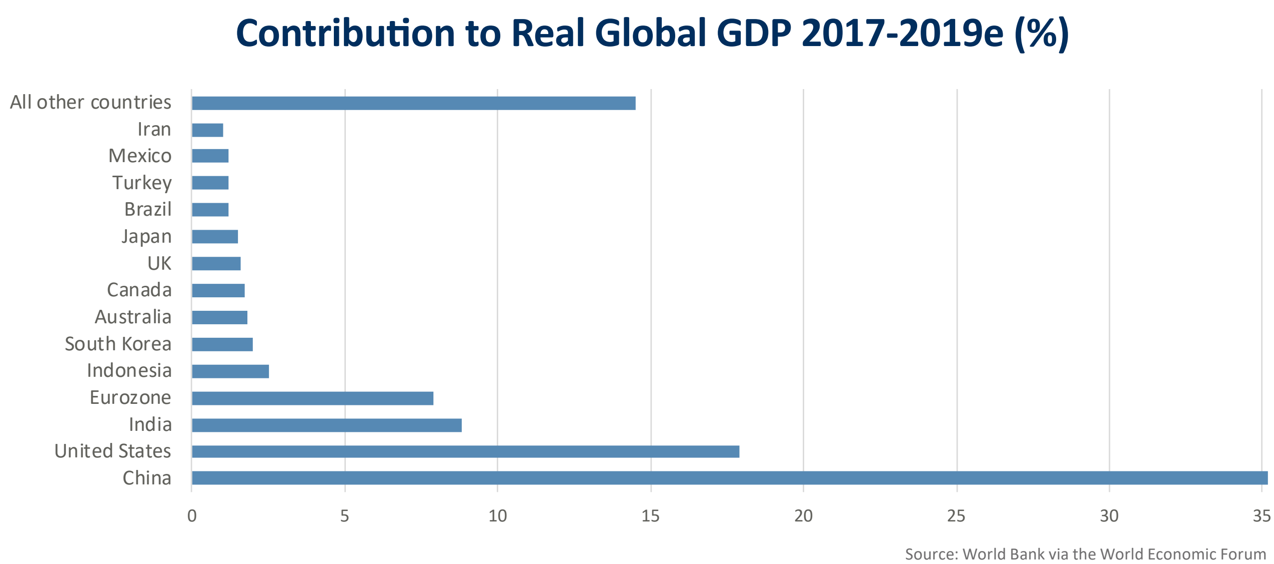

KEEP CALM AND CARRY ON

This question needs to be tackled more directly. Surprisingly then, a potentially more valid strategy is to keep calm and carry on, acknowledging the existence of trade tensions but not regarding them as anything like the sole driver of asset class, market, sector and stock performances. There is certainly something to such a strategy as - ironically - the preponderance of a key macroeconomic variable such as a trade war, allows a sharper differentiation to be made with investments with alternative, positive drivers. The old market adage that 'even in a deep bear market, something is going up' has something going for it. This is supplemented by the observation that efforts to quantify the impact of a trade war are fraught with difficulties. A recent study by the European Central Bank appeared to conclude that China would not be a loser from a trade war. Despite an obvious negative impact threat on exports, the country's ongoing domestic market reforms, including the encouragement of consumer spending, would continue apace. By contrast, American consumers would be impacted by higher import prices, even before the impact on exports was considered. Given such analytical uncertainties, an approach which focuses on true growth themes or an ability to keep paying a certain level of dividend has an attraction. Certainly, periods of dislocation suit the idiosyncratic investor prepared to be greedy when others are fearful. However - as noted before - very few parts of the market truly exist in a vacuum.

This therefore makes the most valid strategy an attempt to understand the potential direction of the current spat, its longevity and materiality, and ultimately what will result. China's singular focus on its economic development over the past generation has achieved huge success and more recent years have seen new efforts to broaden their global influence and role, diplomatically and politically. The recently launched Belt and Road Initiative, which aims to create a trade zone stretching from western Europe back to Beijing, is a clever move to curry favour and build economic and diplomatic friendships. It is perhaps unsurprising a change of US administration has shifted their 'pivot to Asia' diplomatic and trade acquiescence to something much more antagonistic.

This may appear to be a last throw of the dice by the US to stay as the pre-eminent global player, but the reality is that China is not yet even ready to take their place. As a single state party, the long-term perspective, ongoing domestic reform efforts in China are the main policy focus. China will respond to trade antagonism to save face but it is unlikely to aggressively initiate it, especially as they are committed to progressively further liberalising their trade relations. Then throw in the potentially more limited capability of the US administration to push an aggressive trade policy after the midterm elections in early November, and you quickly come to the conclusion that trade fears may actually be at a peak.

In short, the side to choose in the current bout of trade angst is patience, flexibility and those old school active investment skills.

KEY TAKEAWAYS:

- Global fund manager surveys have 'trade war' as the most cited current fear.
- The old market adage that 'even in a deep bear market, something is going up' has something going for it.
- The trade war may appear to be a last throw of the dice by the US to stay as the pre-eminent global player, but the reality is that China is not yet even ready to take their place.
- Periods of dislocation suit the idiosyncratic investor prepared to be greedy when others are fearful.

Can a Brexit Compromise Really Happen?

Chris Bailey, *European Strategist, Raymond James Euro Equities*,* considers some of the barriers and opportunities that the UK is faced with on the road to reaching a deal - or not - with the European Union.

"Let no one think that flexibility and a predisposition to compromise is a sign of weakness or a sell-out"
Paul Kagame

Life is full of surprises. I am pretty certain that UK Prime Minister Theresa May would have preferred not to have been so surprised by the reaction to her Brexit preferences in Salzburg, during late September. However - as with life - it is how you react that really matters.

SORRY NO CHERRIES TODAY

So how do you react? Theresa May's grumpy press conference followed Donald Tusk's now infamous 'sorry no cherries today' Instagram reflecting, if we did not know already, that the whole Brexit process has been a series of forward steps followed by backward one. What was most striking to me however was the sharp distinction between the hope of just a few days prior to the Salzburg summit, when talk of a November - or even possibly an October - final deal was apparent. With time ticking away these scenarios appear less likely... so can a compromise be reached that will solve the Irish border and general future trade relationship, and sell it to Parliaments and underlying citizens?

WHY COMPROMISE?

What is the logic for striking a compromise deal? Well it has to be centred on trade and its contribution to economic activity. After all, from a UK perspective, exports of goods and services to other European Union (EU) countries were worth £274 billion in 2017 (over 40% of total UK exports), while exports from the rest of the EU to the UK were worth about £341 billion. No deal does not stymie this completely, but every new frictional cost or barrier is a hindrance or a loss that has to be overcome or sourced from elsewhere.

ANSWERING THE BORDER QUESTION

Common sense and political/economic decision-making are rarely one and the same thing and the world of Brexit is replete with emotional, instinctive thinking. The Irish border question is clearly one of these issues. Fortunately, the full weight of the history underlying this question is not apparent and policymakers need to just concern themselves in avoiding a 'hard border'. Could technology take up the strain as with so many other elements in our modern lives, tracking goods to their final destination? Certainly a next generation version of the current fluid Swedish-Norwegian border (average wait time nine minutes) or US-Canadian border (average wait time just under sixteen minutes - assuming Fast and Secure Trade Program membership) could exist for the Irish border.

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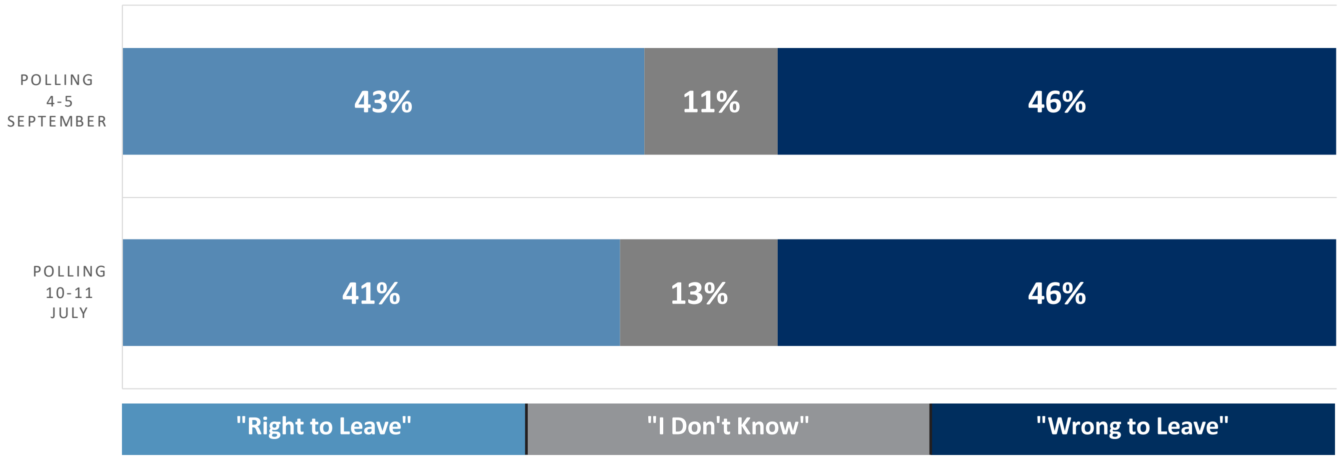
"In hindsight, do you think Britain was right or wrong to vote to leave the EU?"



Source: YouGov

It is clearly not perfect but it is should be good enough to satisfy enough people initially to get something through and agreed

CHEQUERS OR NO DEAL

And then there is trade. The careful compromise of the 'Chequers deal' and its facilitated customs arrangements looks unlikely to politically hold up, and the ongoing EU's binary focus (outside 'no deal') on either something like the current status quo or an off-the-shelf existing 'Canada-style' deal seem at face value to be the only options on the table (and the latter causes Irish border challenges). Clearly, here is where UK politics kicks in, but if you take away those with very firm and vocal views, the closeness of the 2016 referendum - especially when combined with a UK Parliamentary majority in favour of 'remain' - indicates the most likely outcome is for Brexit... but only in a soft and transitional manner. With a twenty-one month transition period already on the table for the post end of the March 2019 period, efforts have already been made to try and avoid an aggressive cliff edge.

Now some will say that such a scenario is impossible because the current UK government will be unable to muster sufficient support on its own benches, however, remember the general, average Parliamentary view, which is likely to be in favour of a soft Brexit at most. At some point - despite obvious party politicking incentives - such a huge constitutional matter cuts across party boundaries irrespective of which political party nominally has a majority (or not). Meanwhile, the trouble with the rationale for a second referendum is that any question gets hijacked and is unclear in a transitional scenario.

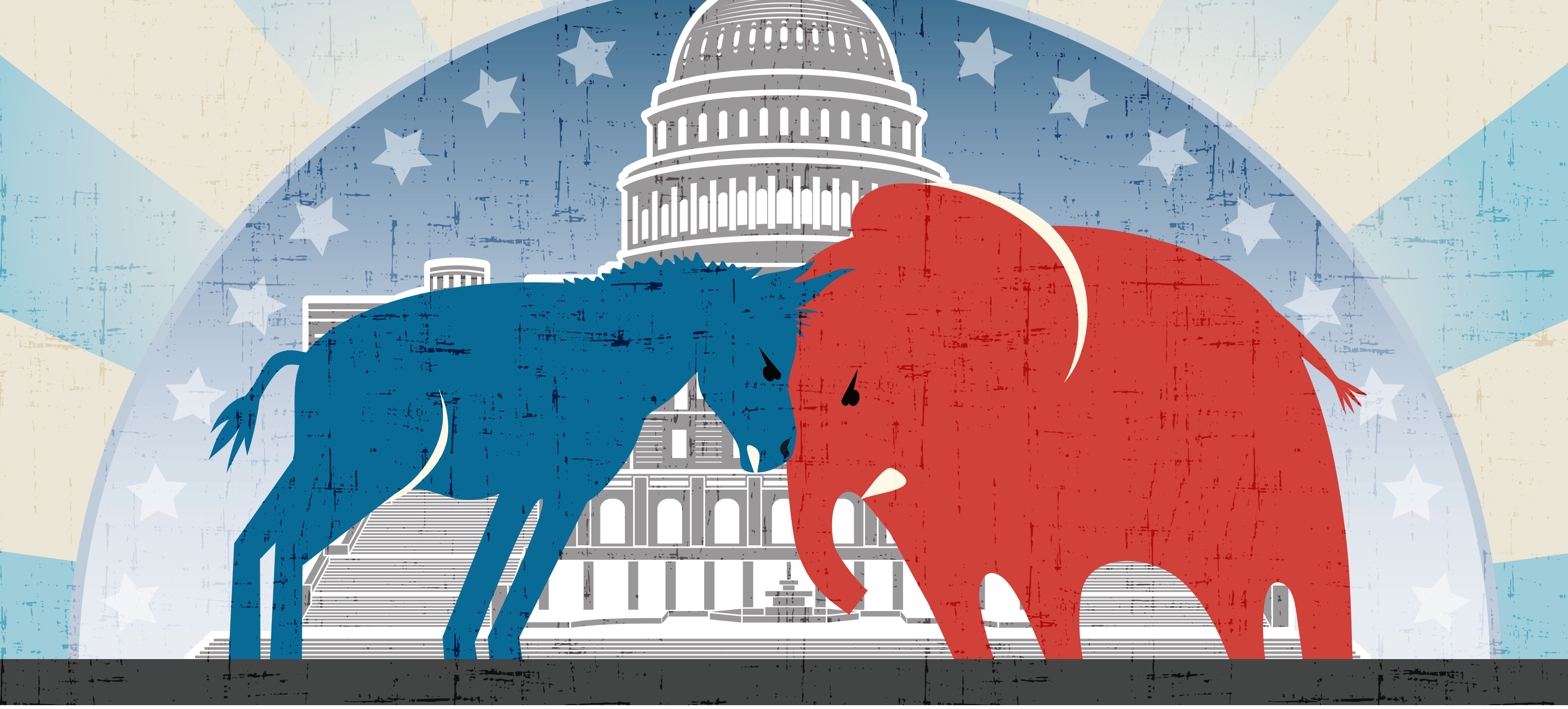
WHAT HAPPENS NEXT

What we have now is clearly an impasse, but not an unassailable one. Brexit, with its step forward and backwards, remains tricky, unclear and newspaper headline catnip. It has held back the Pound, UK domestic shares and even the broader continuing European Union. But from the current desperately mixed sentiment backdrop, any resulting deal will lift all these boats in a potentially tradeable manner for investors.

But - as we started this piece - what happens beyond March 2019 depends on how consumers, businesses and politicians react to any deal. Forging a deal is important but with the backdrop of a competitive, evolving world, what everyone does with it matters much, much more. In short, even with compromises, challenges and opportunities exist with the Brexit debate.

KEY TAKEAWAYS:

- The whole Brexit process has been a series of forward steps followed by backward ones.
- Every new frictional cost or barrier is a hindrance or a loss that has to be overcome or sourced from elsewhere.
- The general, average Parliamentary view - which is likely to be in favour of a soft Brexit - offers some hope of the scope for a compromise deal.
- Any resulting deal could help the Pound, UK domestic shares and even the broader continuing European Union.
- Forging a deal is important but with a backdrop of a competitive, evolving world, what everyone does with it matters so much more.



Elephant in the Room?

Ed Mills, *Washington Policy Analyst, Equity Research,* surveys the current political landscape and the upcoming midterm election.

We are in the final stretch of the midterm elections that we view as a proxy in the fight between President Trump's agenda and the electability of Congressional Democrats. Multiple themes will be given considerable attention in the coming months. In terms of the potential electoral outcomes, we will be paying particular attention to the political environment vs. the electoral map. Adding to the uncertainty of the outcome and potential market volatility will be vigorous debates about polling – with questions of its quality (especially in House races), accuracy, and predictability.

CURRENT VIEW

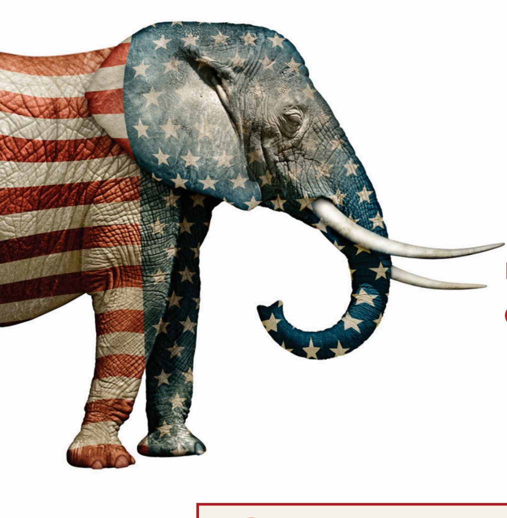
The political winds are at the Democrats' backs, but the distribution of Senate races, the partisan tilt of many House districts, and positive economic indicators could limit Republican losses. That said, we view Democrats as favored to win a majority of seats in the House of Representatives and Republicans favored to maintain control of the Senate. By historical standards an average midterm election would produce a Democratic majority in the House.

> "We view Democrats as favored to win a majority of seats in the House of Representatives and Republicans favored to maintain control of the Senate."

In the House of Representatives, "R" no longer stands for "Republican." It stands for "retirement." House Republicans have more retirements and open seats since at least 1930. Polling is notoriously sparse in House races, but traditional proxies (such as Presidential job approval, generic ballot test and voter enthusiasm) all point to significant gains for Democrats, giving them the edge in the fight for a House majority.

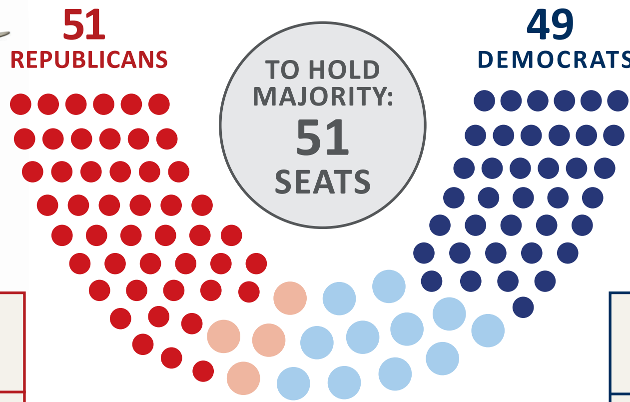
Historical midterm results and an array of surprising Democratic special election victories including Alabama (Doug Jones) and Pennsylvania (Conor Lamb) strengthen the case that Democrats are favored to retake the House.

Democrats need to net two seats for a Senate majority after November's election. In our analysis of these races, we see 11 competitive races in seats currently held by Democrats and only four in seats held by Republicans. Wave elections (an election in which a party makes major gains) can swing these competitive seats in one direction, but Democrats face an uphill battle to retake the Senate.



The Midterm March to Majority

Due to the current composition of the Senate, Democrats face an uphill battle to obtain the majority.



4 Competitive Republican Seats

Arizona	Tennessee
Nevada	Texas

11 Competitive Democratic Seats

Florida	North Dakota
Indiana	Ohio
Michigan	Pennsylvania
Missouri	West Virginia
Montana	Wisconsin
New Jersey	

HOUSE AND SENATE BY THE NUMBERS

Members of the House of Representatives serve a two-year term, and all 435 members are up for re-election in November. Republicans currently enjoy a 44-seat majority with 237 seats compared to 193 seats for Democrats. Five seats are currently vacant. The party with at least 218 seats has a majority in the House.

Senators serve six-year terms and one-third of the Senate is on the ballot every two years. This year that number is elevated to 35 of the 100 senators due to an early retirement and resignation of two senators. Republicans hold 51 Senate seats, while Democrats hold 47 (along with Bernie Sanders and Angus King, two independents who caucus with the Democrats). Given that Vice President Pence serves as a tiebreaking vote, Democrats would need to net two seats for a majority following November's election.

Although gaining two Senate seats appears to be an easily achievable target in the current political environment that suggests a Democratic tailwind, Democrats are defending 26 Senate seats compared to nine for Republicans. Ten Democrats are running in states won by President Trump, including ruby red states like North Dakota, West Virginia, Montana, and Indiana. Republicans are only defending one seat in a state won by Hillary Clinton (Nevada). Structurally, Republicans have the advantage to maintain the majority in the Senate.

The midterm elections are historically challenging for the incumbent party. Since 1938, the party holding the White House has lost seats in Congress in all but two midterm election cycles. The average loss for the incumbent party is 26 House seats.

Generally, the lower the President's job approval numbers, the worse the President's party performs in the election. In 2018, President Trump has consistently polled a net disapproval rating with the latest available data showing a net disapproval rating of 9.3%. Comparatively, President Obama's net disapproval reached a high of 5.3% at the same point in his first term leading up to the 2010 midterm elections, which saw Republicans gaining 63 House seats to claim the majority – the largest swing since 1938.

So far this year, Democrats have consistently led in the generic Congressional ballot, reaching a high of 12.1%. Comparatively, Republicans polled as high as 10% in 2010. The current Democratic advantage is 6.9%. Democrats are also showing an advantage in voter enthusiasm, particularly in toss-up states.

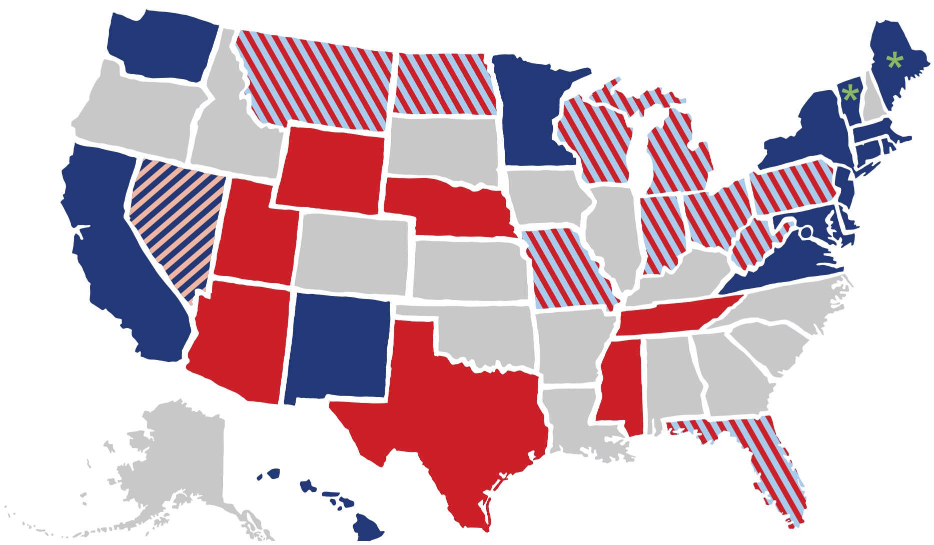
Election watchers typically pay attention to retirements and candidates seeking other offices ahead of the election cycle to gauge the candidates' sentiment. According to Pew Research, the current number of House Republicans voluntarily giving up their seats – including House Speaker Paul Ryan – is at its highest since 1930.

PROJECTION AND OUTLOOK

Based on the current trajectory and historical comparisons, our base case for the 2018 midterms is Republicans retaining a Senate majority with the House switching to Democratic majority control. A Republican Senate and a Democratic House could potentially create

Challengers' Trump Card

Many incumbent Democratic senators are running for re-election in states Trump won in the 2016 presidential election.



> "A Republican Senate and a Democratic House could potentially create a Goldilocks scenario for the market: not too hot, not too cold."

a Goldilocks scenario for the market: not too hot, not too cold. We strongly believe that the strength of the market since President Trump's election has been tied to his deregulatory agenda. The Senate alone confirms Presidential nominees, which require a simple majority vote. A Republican Senate equals a continuation of the Trump deregulatory agenda.

In the House, we would be looking for potential breakthroughs on immigration, infrastructure, and a potential fix to the SALT[1] deductions as possible agenda items. Divided government is likely to produce spending bills that keep domestic and defense spending at or near current levels, continuing a legislative agenda that supports fiscal stimulus. Should the Democrats retake enough seats, a key concern for the market would be increased oversight by the House.

Caveats to consider to the current forecast are candidate recruiting, the strength of individual candidates, new district maps, and the strength of the economy, which could serve to limit potential Republican losses this fall.

KEY TAKEAWAYS:

- We view Democrats as favored to win a majority of seats in the House of Representatives and Republicans favored to maintain control of the Senate.
- We strongly believe that the strength of the market since President Trump's election has been tied to his deregulatory agenda. A Republican Senate equals a continuation of the Trump deregulatory agenda.
- A key concern for the market would be the impact of increased oversight in the House.
- Caveats to consider to the current forecast are candidate recruiting, the strength of individual candidates, new district maps, and the strength of the economy, which could serve to limit potential Republican losses this fall.

[1] SALT: State and Local Tax

Is Inflation Coming Back?

Chris Bailey, *European Strategist, Raymond James Euro Equities*,* reviews tha various global indicators for inflation and breaks down what this might mean for investors.

"Inflation is taxation without legislation'" Milton Friedman

Unlike each of the last few years, relatively few of the world's major financial markets outside of American equities or energy sector shares, have made a real return - that is beating inflation - during 2018. At one level, this is not unexpected as the global stock market cycle moves closer to a decade since the early 2009 Global Financial Crisis low point, however it raises some uncomfortable questions for investors: is there a legitimate concern that inflation is coming back?

INFLATION & INTEREST RATES

Inflation has always mattered for investors. For fixed principal investments such as bonds, it is a major concern as it can significantly reduce purchasing power over time. By contrast, equities (via individual companies) and commodities have more of an inbuilt ability to raise prices.

One of the most powerful theories in economics is the Fisher effect which states that the real interest rate equals the nominal interest rate minus the expected inflation rate, or - to put it very simply - interest rates go up when inflation goes up. If we think about much of the rationale for the strong performance of financial markets, low interest rates have played a very important role. So if inflation - or even inflationary expectations - rises, then interest rates inexorably are likely to rise too. And looking at the aforementioned asset class performance so far during 2018, we have already seen the impact of higher interest rates.

> "One of the most powerful theories in economics is the Fisher effect which states that the real interest rate equals the nominal interest rate minus the expected inflation rate."

FIXED INCOME

If we start with fixed income, one of the first rules a nascent investor learns is that bond prices are inversely related to interest rates i.e. if interest rates go up then bond prices go down. Looking at the poor performance of fixed income securities globally during 2018 to date, this appears to confirm rising inflationary fears. However, there are other elements at work, such as the ongoing quantitative tightening that the Federal Reserve started just over a year ago.

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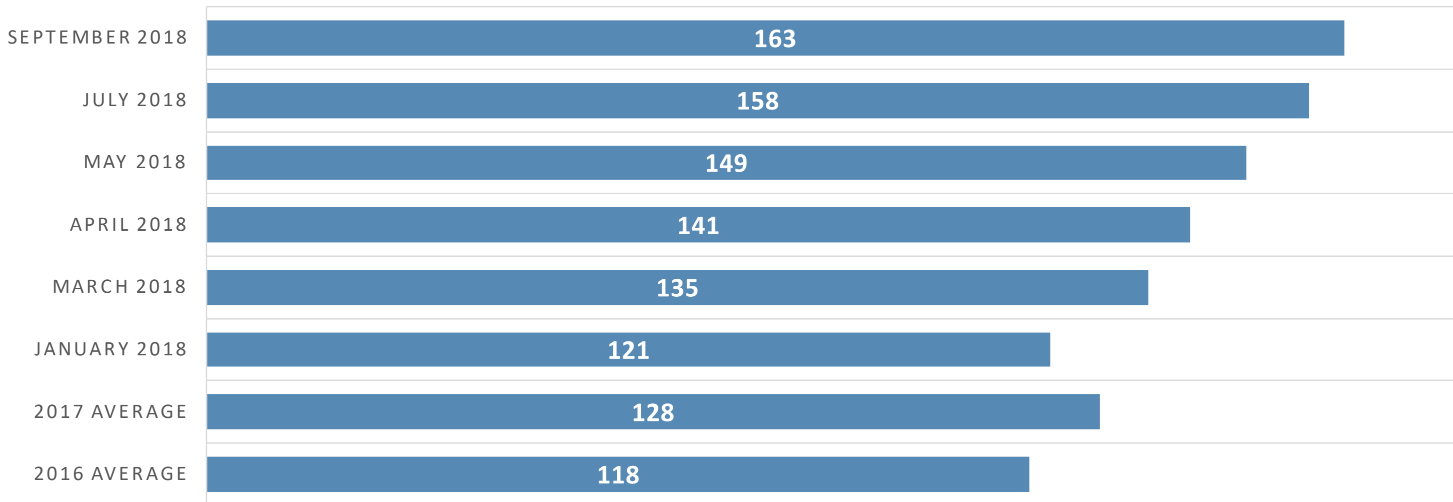
The Beige Book: How Many Times did the Fed Mention Inflation?

Recent months have seen inflation mentions in the Federal Reserve's influential Beige Book surpass averages for both 2016 and 2017



> "Elsewhere in the world, such inflationary pressures are not as obvious, but they are quietly rising in line with energy prices and any global trade angst related import cost inflation"

COMMODITIES

The decomposition of bond yields allows some insight into the progress of inflationary expectations, which have been on the rise quietly over the past couple of years in the United States. The 5-Year, 5-Year forward inflation expectation rate - a measure of the average expected inflation over the five-year period that begins five years from the date data is reported - has risen from 2% in 2016 to just over 2.4% currently. However what is particularly striking over the last five years is the directional correlation of this measure with the Brent crude price, a commodity price which reached a four-year high during early October. Oil prices are always desperately macro influenced but - if we try to bring all the themes and influences together - the years of low investment in the energy space by oil companies desperate to shore up their balance sheets at a time of lower commodity prices, has created a backdrop which is supportive of prices. As an aside, these oil price insights reflect a pretty direct linkage between commodity prices and inflation.

INFLATION INDICATORS

Meanwhile other inflation indicators in the US are hotting up, including mentions in the influential *Beige Book* and in corporate quarterly earnings transcripts, reflecting both higher commodity input prices and some signs of wage inflation. Additionally, there remains the scope for some inflationary consequences from global trade complications, such as tariffs on goods imported from China. Bringing it all together, inflation is not rampant in the United States but it has firmed and - applying the Fisher effect - it supports further increases in interest rates by the Federal Reserve.

RISING PRESSURES

Elsewhere in the world, such inflationary pressures are not as obvious, but they are quietly rising in line with energy prices and any global trade angst related import cost inflation, even in the relatively slow growing Eurozone and Japan. This has been matched by bond yields edging up in the world outside the US, raising the spectre of another bout of lacklustre performance by fixed interest assets. Additionally, patchy productivity growth from many countries worldwide, which limits the ability to grow in a non-inflationary manner, has been a notable feature of many central bank communications, including from the Bank of England. To improve this latter capability, we would need to continue to see supply-side change and reform which builds flexibility and dynamism in underlying economies.

EQUITIES

And what about the impact on global equity markets? Higher interest rates are typically not good for risk assets as it raises the hurdle for companies to borrow money or analysts to discount investment opportunity. This could, in particular, impact the perception towards growth companies - including many companies in the technology and internet-related sectors which have been extremely influential in pushing up many global equity markets. A bit more inflation raises the likelihood of rotation towards a broader range of sectors, and towards individual companies that can exhibit pricing power. The latter trait is likely to be an increasingly important one for all investors to look for when selecting individual equity investments.

THE IMPACT OF RAISING INTEREST RATES

Overall, in terms of concerns about inflation build - augmented by commodity shifts, world trade disruption impacts and the capability to boost productivity via change and reform - possibly the bigger impact will come from the impact on raising interest rates, with direct knock-on effects for both equity and fixed income investments.

As an investor, inflation matters.

> "Higher interest rates are typically not good for risk assets as it raises the hurdle for companies to borrow money or analysts to discount investment opportunity."

KEY TAKEAWAYS:

- Inflation has always mattered for investors.
- If inflation - or even inflationary expectations - rises, then interest rates inexorably are likely to rise too.
- Other inflation indicators in the US are hotting up including mentions in the influential Beige Book and in corporate quarterly earnings transcripts.
- A bit more inflation raises the likelihood of rotation towards a broader range of sectors and towards individual companies that can exhibit pricing power.
- The biggest impact will come from the impact on raising interest rates.

Trading Places: Value & Growth

Andrew Adams, CFA, CMT, *Senior Research Associate, Equity Research,* reflects on the rally in growth stocks over the past decade and highlights the tailwinds that are likely to keep them in the lead over value for some time.

One fundamental decision to make when investing in the equity markets is whether to favor growth strategies or value strategies. The two styles represent contrasting approaches to stock selection, and this dichotomy often divides investors who naturally gravitate toward one or the other. However, either strategy can be a better choice in a favorable underlying environment, and having a portfolio tilted toward the right style at any given time can go a long way to boost returns. First, though, it is important to distinguish between growth and value stocks.

GROWTH STOCKS

Growth stocks are companies expected to grow their sales and earnings at a high rate, typically above that of the average stock in the market. Much of the growth stock's worth is tied to its future earnings potential, which is why they tend to trade at higher than average valuation multiples. Growth companies also usually opt to reinvest profits back into their businesses instead of paying out high dividends, and investors are okay with that because they believe they'll be able to sell their shares for much more in the future as long as the company continues to grow.

VALUE STOCKS

Value stocks trade at a discount to some calculated measure of intrinsic value. They tend to have lower valuation multiples, higher dividend yields, and lower expected future growth rates compared to growth stocks. Value investors feel there is a 'margin of safety' in buying a stock that is already trading below what they believe it to be worth, but they have to be careful not to fall into the 'value trap' of buying something that is 'cheap' for a good reason.

Proponents of value stocks are quick to point out that they have outperformed growth stocks over the past several decades, but in recent years that dominance has swung the other way. Since 2006, the Russell 3000 Growth Index (a proxy for all U.S. growth equities) has consistently outperformed its counterpart, the Russell 3000 Value Index, with few notable exceptions. That 12-year advantage for growth has left many value investors wondering just when it will be their turn again. We believe there are a few fundamental reasons why growth has dominated over the past decade, and these tailwinds do not yet show material signs of reversing, which is why we continue to favor growth stocks.

FUNDAMENTALS STILL FAVOR GROWTH

The broad stock market has performed quite well over the past several years, pushing up valuations and offering fewer value

Two Sides of the Coin: Value & Growth

VALUE STOCKS
These companies are often priced based on their current value and distribute a larger portion of current earnings to shareholders.

GROWTH STOCKS
As their name suggests, these companies often reinvest their earnings into future growth opportunities.

opportunities overall. Consequently, investors have piled into stocks with greater earnings growth potential that can better justify the higher valuations. Value tends to lead as recessions near, as investors sell their high-flying growth stocks and move into more stable companies, and when coming out of a market downturn, when beaten-down stocks have more room to rise. As a result, it should not come as a complete surprise that, since 2006, the periods when value has been the better performer have mostly come after meaningful sell-offs in the broad market. We think these sell-offs help create more value opportunities when they occur, and relative performance improves while those beaten-down companies return to fair valuations. Therefore, it may require more of a significant decline in the broad market to put the wind at the backs of value stocks again.

INTEREST RATES AND EARNINGS GROWTH

Interest rates have been near historical lows for the last several years. Lower interest rates translate to a lower discount rate when valuing future earnings, which means future earnings are worth more when discounted back to the present. Relatedly, with interest rates and economic growth as low as they have been over the past few years, many investors have been reaching for returns in equity investments to make up for the lackluster yields in fixed income. A 'barbell-type' strategy has been quite common for investors, as they balance less volatile, low-yielding bonds with stocks that have potential for capital gains. As rates rose over the last couple of years, demand for the lower growth, higher dividend-yielding stocks commonly used as bond proxies appears to have fallen more than demand for the high earnings growers. A stock with a 2-3% dividend that is not expected to grow at a high rate simply becomes less attractive as more competitive yields can be found in fixed income. A stock with the potential to grow earnings at a high rate is not as affected by rising rates while they are still considered to be at low levels overall.

> As interest rates rise, they erode the present value of future earnings, whereas when interest rates fall, they increase the present value of future earnings.

PASSIVE VS. ACTIVE INVESTING

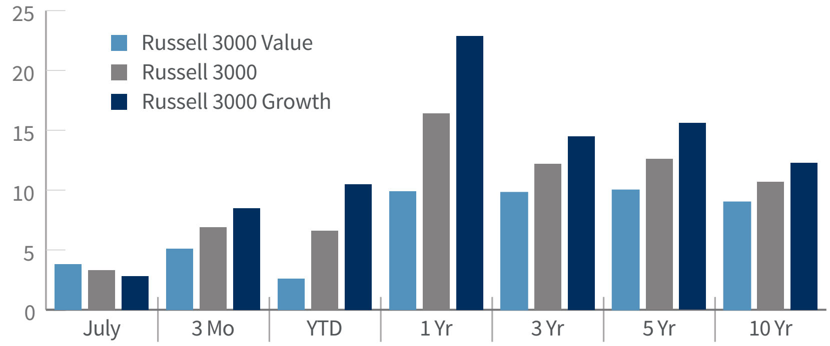
The massive shift to passive investing benefits growth stocks at the expense of value stocks. Historically, active investors and portfolio managers have generally favored value investing strategies. However, as more money flows into products that 'buy the market' or 'buy a sector,' value is largely being thrown out the window. Instead, stocks that are bid up to higher valuations rise in market capitalization and become even larger holdings within these funds, while stocks that fall become smaller holdings. In other words, there's a built-in momentum factor that doesn't exactly help stocks that are 'undervalued.' It's probably not a huge coincidence that the clear outperformance of growth over value going back to 2006 has occurred at the same time passive investing and index funds have proliferated.

TRADING: COST AND EFFICIENCY

On a closely-related note, it used to be more costly and time-consuming to research and trade stocks, and it was near impossible for the average investor to try to duplicate an index or even to hold

Growth Outperforming Value

Over the past decade, growth has outperformed value on a relative basis.



Source: Russell, as of 07/30/2018

a large basket of stocks in a portfolio. As a result, more emphasis was placed on finding the sub-section of stocks that represented exceptional value opportunities, and then holding them until they were no longer a good value (or paying an active manager to find those opportunities).

Now, online brokers offer extremely low-commission stock trades and index funds enable investors to own the majority of the world stock market's capitalization at little cost. The ability to trade so quickly and cheaply has helped to cut down on holding times and has prompted investors to chase quarterly earnings growth and whatever is hot at the moment, further skewing the market toward growth stocks. Moreover, as investing becomes easier and cheaper, more money flows directly into stocks. Since that money is increasingly going toward passive strategies and growth stocks these days, it has almost become a self-perpetuating cycle.

TECHNOLOGY AND DISRUPTION

The increasing importance of technology to our overall economy naturally favors growth strategies over value. Companies that chiefly depend on innovation and continual progress (like those predominantly found in the technology sector) often trade at higher-than-average valuations, but can still be attractive to investors because they are expected to generate higher-than-average earnings growth in the future, even if they're not currently profitable. As technology-oriented companies continue to innovate and disrupt established industries, more and more of the disrupted companies have turned into value traps that underperform for years.

THE BOTTOM LINE

The bottom line is that growth stocks have dominated value stocks for over a decade now, and it might require some sort of a recessionary environment or paradigm shift to really flip that relative strength on a longer-term basis. There will be periods when value does better, and there will always be attractive individual value situations on the company level. However, we believe long-term investors taking a more active approach should still remain focused on the growth-type companies and sectors that have been in favor in recent years until there are clearer signs that the underlying trends have changed.

KEY TAKEAWAYS:

- The broad stock market has performed quite well over the last several years, pushing up valuations and offering fewer value opportunities overall.
- With interest rates and economic growth as low as they have been over the last few years, many investors have been reaching for returns in equity investments to make up for the lackluster yields in fixed income.
- Moreover, as investing becomes easier and cheaper, more money flows directly into stocks. Since that money is increasingly going toward passive strategies and growth stocks these days, it has almost become a self-perpetuating cycle.
- The increasing importance of technology to our overall economy naturally favors growth strategies over value.
- The bottom line is that growth stocks have dominated value stocks for over a decade now, and it might require some sort of a recessionary environment or paradigm shift to really flip that relative strength on a longer-term basis.

To Invert, or Not to Invert?

Doug Drabik, *Senior Strategist, Fixed Income,* and **Nick Goetze,** *Managing Director, Fixed Income Services,* assess the current state of the U.S. yield curve and their outlook for interest rates.

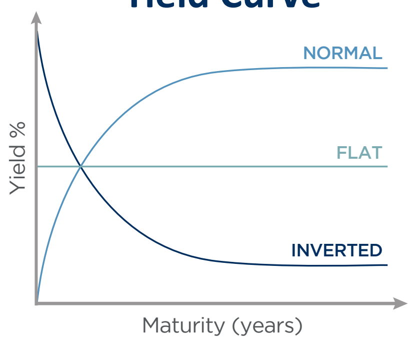
Given its position as the world's most important central bank, recent interest rates increases by the U.S. inevitably has global implications. This is particularly true as the U.S. yield curve has also continued to flatten which, in turn, has prompted investors to question whether the yield curve will become inverted (a scenario in which short-term interest rates become higher than long-term interest rates). Historically, inverted curves have often proven to be precursors to recessions - which clearly would be a concern for all global investors.

WHERE DID THEY COME FROM?

Record low interest rates can distort perceptions when assessing yields and fixed income in general. On July 8, 2016, the yield on the 10-year Treasury note closed at its three year low of 1.36%. The yield on the 10-year Treasury has since climbed to 3.07% at the time of this writing. On a relative basis, this constitutes a rise of over 126% when compared to its yield in July 2016. While this rise certainly appears large, it is important to keep it in context; on a nominal basis, the yield on the 10-year Treasury has only risen 1.78 percentage points, or 178 basis points (bp). Over the past 50 years, the average yield on the 10-year Treasury has been 6.37%. It is worth noting that yields were skewed substantially higher during the first 25 years of that period as the Fed tried to tame high inflation. On the other hand, yields over the past 15 years have been skewed substantially lower as the Fed tried to spur economic growth following the financial crisis of 2008.

The yield curve is created by plotting the yields of fixed income investments of various maturities. In the case of the U.S. Treasury yield curve, the yields of Treasuries from one month to 30 years in maturity are plotted along an axis. The line connecting these points is known as the 'yield curve' due to its distinctive curved shape. Generally, short-term yields are lower than long-term yields, creating a curve which slopes up and to the right. When short-term and long-term yields are similar, the curve appears 'flat.' When short-term yields are higher than long-term yields, the curve becomes 'inverted,' sloping down and to the right.

Yield Curve



It bears mentioning that points along the yield curve have not

Alternate Sources of Yield

James Camp, CFA, *Managing Director of Fixed Income, Eagle Asset Management*,* discusses the difficulties facing dividends and his outlook on future distributions.

Just as value stocks lagged growth stocks over the last couple of years, a similar trend can be seen between income-producing stocks and the broader equity markets. Non-paying larger cap stocks outpaced dividend payers by over 10% in 2017. Moreover, within the dividend-paying space, higher-paying dividend stocks experienced similar underperformance relative to their lower-paying counterparts.

While non dividend-paying stocks only make up 16% of S&P 500 companies, they have provided an outsized portion of recent returns. Conversely, returns on high-yielding dividend securities have turned negative year-to-date, despite a recovery in July. Dividend-paying stocks are sensitive to rising interest rates, due in part to the higher amount of debt typically carried by these companies. As rates rise, so does the cost of servicing debt, ultimately dampening profits and placing pressure on stock prices.

Despite a challenging rate environment, dividends continue to grow and reacceleration is occurring in many sectors, including financials, where regulatory reform is freeing up capital for increased payouts. Income investors would do well to remember that dividend-based strategies adhere to an 'objective-based' approach, and, in that context, these strategies are meeting that objective by delivering income.

Going forward, headwinds in this space include a potential market correction and rising interest rates, with higher-paying dividend stocks being the most sensitive to these events. More modest paying companies, which yield slightly more than the S&P 500 as a whole, have historically provided the best risk/return characteristics.

In the past 15 years, there have been nine periods when the 10-year Treasury yield had a significant move (approximately 100 basis points or more). Modest-yielding stocks suffered only two periods of negative returns, while the S&P 500 High Yield Dividend Index fell in three periods. The average returns during these periods for the two groups were 6.88% and 4.38%, respectively.

Source: FactSet

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

moved uniformly. On the contrary, short-term yields have risen while long-term rates have remained relatively unchanged. Today's yield curve shape is a product of both the Fed's methodical short-term interest rate hikes and investor sentiment, which has held intermediate and long-term rates in place. In addition, persistently low interest rates around the globe have created steady demand for U.S. Treasuries, which have relatively higher yields than most sovereign debt from around the world. Along with weaker global growth, geopolitical risk, a strengthening dollar, and low inflation, this has proven to be a strong headwind to higher intermediate and long-term interest rates.

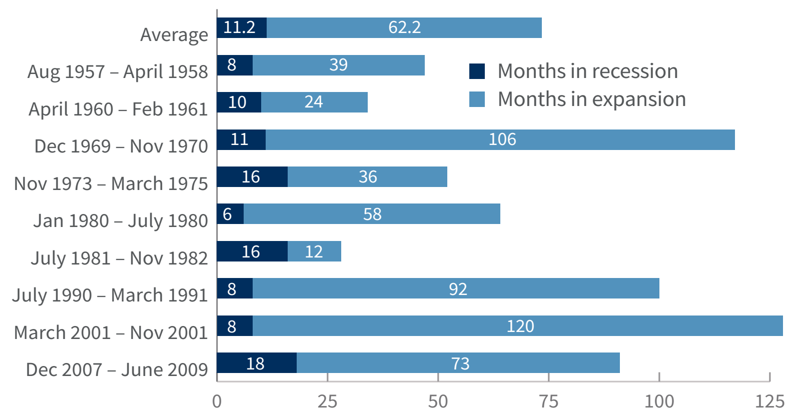
THE ECONOMIC CYCLE

Parts of a normal economic cycle include expansions and recessions. An inverted curve signifies that shorter-term rates are higher than longer-term rates. In recent history, inversions have preceded recessions. Historically, equity markets have peaked after the start of an inverted curve. The prospect of a looming recession can incentivise investors to buy bonds with longer maturities as a safe-haven trade in the face of falling equities and/or as a method of preserving capital, potentially causing a fall in long-term yields. Since bond prices rise as yields fall, falling fixed income yields often lead to total return gains. This inverse correlation allows high- quality fixed income to potentially act as a balance to growth assets, such as equities.

It is important to keep in perspective that, on average, periods of economic expansion have been much longer than periods of recession, and positively sloped curves persist much longer than inverted curves. As a result, attempting to 'time the market' based on the shape of the yield curve is an extremely difficult technique for fixed income investors focused on total return. Since long-term planning is typically the norm, it is more of a distraction for fixed income investors seeking income and portfolio preservation strategies. Each of the last three recessions has given way to three of the longest expansionary periods in recent history: March 1991, November 2001 and June 2009. Over the last 60 years, expansionary periods are, on average, roughly 5.5 times the length of

The economic business cycle goes through periods of expansion and growth, as well as periods of contraction and recession. A recession can be severe or mild. It does not mean that there is necessarily an economic collapse, but signals that economic activity has declined for several months and/or consecutive quarters.

The Calm Outlasts the Storm: Expansion and Recession Lengths



Source: Federal Reserve Bank of St. Louis; Raymond James, as of 09/15/2018

recessionary periods. That margin has widened in recent history. Over the last 30 years, expansionary periods are, on average, more than 8.6 times the length of recessionary periods.

Experts in the fixed income space often monitor spreads between different points on the yield curve in order to forecast economic trends and investor behavior. For example, many prefer to look at the spread between the yield on the 2-year Treasury and the 10-year Treasury. The graph on the following page illustrates the 2-year versus 10-year Treasury spread (light blue line) and the federal funds rate (dark blue line) over the past 30 years. When the light blue line falls below the horizontal '0' axis, the yield curve has become inverted. This 30-year timeline includes four periods of major Fed rate hikes, three periods of major Fed rate cuts, three recessions, and three inverted yield curves.

THE FED'S ROLE

The Fed attempts to keep the markets stable by staving off economic instability caused by inflation or deflation. At the risk of invoking the phrase 'this time is different,' one of the more dangerous mantras of our industry, this time just may be different to a certain degree. Unlike the last three periods of previous rate hikes by the Fed, this time the hikes began after over seven years of interest rates at 0%. As a result, the Fed may be less focused on an overheated market and more focused on reaching 'neutral' interest rates after a period of unusually low rates. A 3.00% federal funds rate is widely viewed to be 'neutral' by policymakers. This would entail another four or five rate hikes of 25 bp each. The Fed raised rates in September and a December hike is looming. These hikes alone could induce the yield curve to invert.

Some Federal Reserve presidents have stated that their greatest concern is inflation, not necessarily the shape of the yield curve. They are more worried about high inflation than low inflation. These statements remind us that the Fed's mandate is to create a stable monetary environment. Given that this mandate will continue to take precedence over the shape of the yield curve, continued rate hikes increase the possibility of an inverted curve and, with it, concerns of a recession. If the Fed pushes short-term rates too high too fast, it could cause the yield curve to invert. Keep in mind that the Fed has relatively less influence upon intermediate and long-term rates. Should short-term rates rise above intermediate and long-term rates, economic models and investor sentiment may very well turn an inverted yield curve into a self-fulfilling prophecy and thereby 'will' the economy into a recession.

WHERE DO THEY GO?

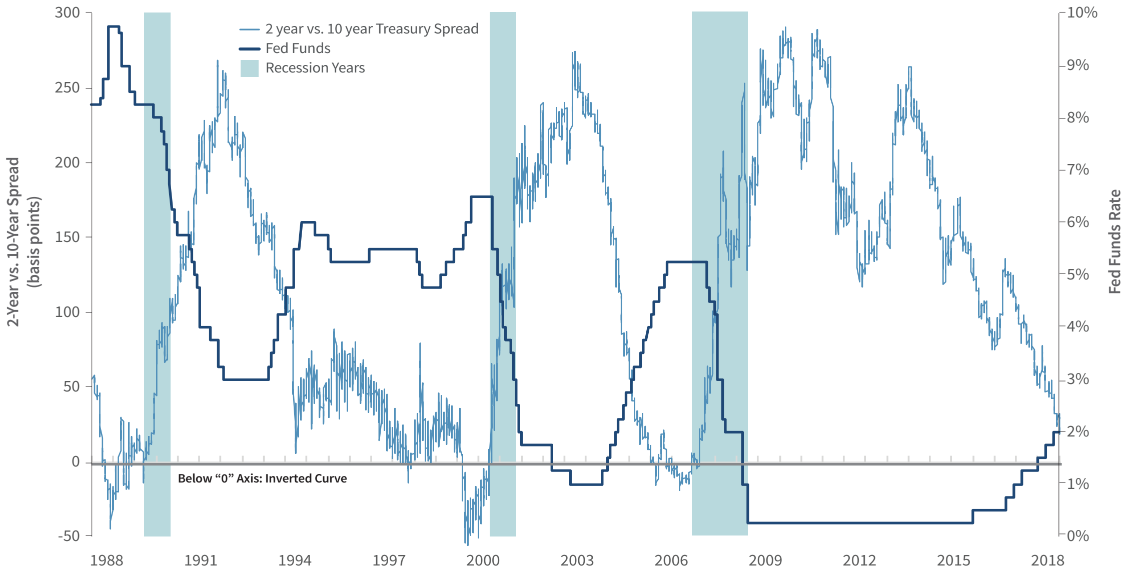
There are currently more headwinds than tailwinds for intermediate to long-term interest rates. As a result, they are likely to be range bound. We anticipate the yield on the 10-year Treasury to remain range bound between 2.80% and 3.40%. Given that the economy continues to show solid growth, there is reason to believe the Fed will continue its gradual pace of hikes and that intermediate and long-term rates will not keep pace, thus causing a yield curve inversion. With U.S. fundamentals still relatively strong, the reaction of the market will dictate where we head from there.

INVESTING AMIDST INVERSIONS

When creating a fixed income strategy/allocation, investors would do well to focus on long-term planning rather than attempting to predict future rates.

A common response to a flatter yield curve is to invest in bonds with shorter maturities. However, an inverted curve does not necessarily mean that short maturity bonds are optimal. For example, on 3 July, 2000, the 2-year Treasury yield of 6.29% was higher than the 10-year Treasury yield of 5.99%. However, after maturity on 3 July, 2002, the funds from the 2-year Treasury would need to be reinvested. Here, investors faced a much different rate environment. By that time, the yield on the 2-year Treasury had fallen to 2.79% and the yield on the

2-Year vs. 10-Year Treasury Spread vs. Fed Funds



Source: Bloomberg LP; Raymond James as of 09/15/2018

10-year had fallen to 4.76%.

Investing in fixed income requires a different approach than investing in growth assets. Fixed income allocations are typically not designated as total return assets, which should remove the motivation to time the market for most investors. Disciplined, long-term planning can combat unpredictable market forces. Short-term thinking would lead an investor to buy short-term maturities when the yield curve is flat. However, hindsight shows that buying short maturity bonds turned out to be a less attractive investment, as confirmed by our previous example.

Years of general interest rate decline have dropped rates to near historic lows, making it reasonable to presume that interest rates may continue their recent mild upswing. While it is nearly impossible to accurately predict interest rate direction and reliably time the market, promoting a more engineered fixed income strategy (such as laddered maturities/duration) may mitigate interest-rate risk, optimize return, and create structured reinvestment. Fixed income allocations may create a better hedge to heavily weighted growth allocations (such as equities) with modestly higher duration bonds. Regardless of yield curve shape, asset allocation is crucial. Due to the fact that allocations to equities and fixed income depend largely on individual needs and goals, investing in fixed income assets requires disciplined, long-term planning.

KEY TAKEAWAYS:

- An inverted curve and recession are words that can often elicit intimidation and lead to distorted investment practices. However, maintaining appropriate portfolio balance and perspective may help investors navigate through these markets.
- Persistently low interest rates around the globe have created steady demand for U.S. Treasuries, which have relatively higher yields than most sovereign debt from around the world. Along with weaker global growth, geopolitical risk, a strengthening dollar, and low inflation, this has proven to be a strong headwind to higher intermediate and long-term interest rates.
- Promoting a more engineered fixed income strategy (such as laddered maturities/duration) may mitigate interest-rate risk, optimise return, and create structured reinvestment. Fixed income allocations may create a better hedge to heavily weighted growth allocations, such as equities.
- Regardless of yield curve shape, asset allocation is crucial. Due to the fact that allocations to equities and fixed income depend largely on individual needs and goals, investing in fixed income assets requires disciplined, long-term planning.

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