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INVESTMENT STRATEGY QUARTERLY

TRADE, DISPUTES AND NOVEMBER'S ELECTION

page 4

An Interconnected World

The US election has ramifications around the world.

Letter from the Chief Investment Officer

On the Road to Recovery

This October marks 80 years since the opening of the Pennsylvania Turnpike, America's first highway. Highways have been a critical driver of economic growth due to the connectivity, speed, and efficiency they provide. As Confucius so appropriately stated, "*roads were made for journeys, not destinations.*"

The last six months have undoubtedly been a challenging journey as the world grapples with the COVID-19 outbreak. While we wish we could have bypassed the pandemic and its accompanying twists and turns, investors have learned that it is critical to focus on the road ahead rather than the rear-view mirror. The virus understandably caused us to reroute our original 2020 outlook, but we are confident there is light at the end of this unwelcome COVID-19 tunnel. We may not have hit the last bump in the road just yet, so adhering to a disciplined investment strategy will be of the utmost importance if you wish to arrive at your destination, achieving all your goals and objectives.

The road to recovery has been under construction since our real-time activity metrics bottomed in April, and the US economy has improved from the severely depressed levels experienced during the shutdowns. Now, with the fastest and most economically destructive recession in modern history behind us, third quarter GDP is revving up to grow 25-30%—the best quarter of growth on record. Despite this, there are still many miles to go before the size of the economy returns to pre-COVID GDP levels (forecast of approximately -3% GDP for 2020, accelerating to about 2.7% in 2021). The recovery is unfolding in a 'K-shaped' pattern, where different parts of the economy recover at dissimilar paces and magnitudes. This expectation is cemented by our assessment that the pandemic inherently favours certain sectors and industries more so than others, allowing certain companies (e.g., e-commerce, medicine, air freight) to enter the express lanes while forcing others (e.g., airlines, hospitality, leisure) to wait until the COVID-19 gridlock clears. Ultimately, a vaccine could alleviate this congestion and the lingering psychological impact of the virus, but even if a safe, effective candidate is approved by year end (80% - 90% probability) it would likely only be available for certain subsets of the population (e.g., medical professionals), with widespread distribution not occurring until mid-2021.

The pandemic's prolonged impact makes it increasingly important for the US Congress to pass a Phase 4 fiscal stimulus deal that bridges our economy to more normal times. Jobless claims remain elevated, with much of the lost wages occurring in the lower income brackets. However, the recent bounce in economic data combined with Congressional leaders' continuing resolution to fund the government through December 11 has resulted in a roadblock in negotiations, likely postponing a deal until after the election. In contrast, the Federal Reserve has performed ongoing maintenance to its already accommodating monetary policy in order to support Main Street, which includes holding short-term interest rates at zero through at least 2023.

The economic recovery may help the 10-year Treasury yield drift higher to ~1% by year end and 1.40% over the next 12 months, but upside movement will likely be constrained. With low inflation, central bank buying, and strong foreign demand, Treasury yields have no license to move significantly higher. In this low yield environment, we see a caution sign on the high-yield bond sector due to rising default risk and sector exposure, and instead encourage investors to follow the Fed's path of purchasing investment-grade debt and municipal bonds. Emerging market bonds are becoming increasingly attractive as well, and our bias toward this sector is complemented by our expectation of further weakness in the dollar.

For equity investors, elevated valuations and a bifurcated market have led to questions regarding the vitality of the second strongest bull market in US stock market history. However, valuations are attractive on a relative basis, and the equity market is supported by the ongoing economic recovery, low interest rates, optimism about the development of a vaccine and additional therapeutics, and a rebound in earnings growth in 2021. Despite their stark outperformance year-to-date, we prefer large-cap, growth-oriented sectors such as Technology, Consumer Discretionary, Communication Services, and Health Care. In fact, the (value-oriented sectors) road less travelled may be for a reason, as our preferred sectors have superior visibility for earnings growth. Case in point, Technology sector earnings will benefit from the building of the 5G highway, artificial intelligence, driverless cars, and a continuation of the work-from-home trend.

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Other, more traditional value sectors such as Energy, have a cloudier outlook. Oil market fundamentals remain rather pedestrian, as the rebound in economic growth has not boosted demand for transportation fuels back to pre-pandemic levels. Numerous countries and US states are still engaged in modified lockdowns, and the oil market needs to avoid a second-wave induced detour during the upcoming winter season as it would surely lead to intensified restrictions. OPEC discipline and a decline in US production have offset a large portion of the reduction in demand, thus allowing oil dynamics to reach equilibrium.

Accordingly, our price target for West Texas Intermediate (WTI) at year end is $40 per barrel (bbl) with potential to rise above $50/bbl over the next 12 months, contingent on stronger fuel demand globally. While there are COVID-19 related risks to the market (vaccine setbacks, potential second wave), the outcome of the presidential race is at the forefront of investors' minds. The polarized political environment was exacerbated by the COVID-19 outbreak, and with the election quickly approaching, voters are truly at a crossroads. For incumbent President Trump, a unique, virus-induced recession as well as high levels of unemployment have threatened his re-election efforts. However, a strong third quarter GDP report released just five days ahead of the election may provide him with the boost he needs. Former Vice President Biden currently has the edge, but this election cycle is likely to be unprecedented—from the debates to the final counting of results.

Regardless of the outcome, we encourage investors to view the winner of the White House as only one factor in determining your asset allocation and sector positioning. The economy, earnings growth, Fed policy, and underlying secular trends combined create a more robust outlook. In fact, many generally accepted doctrines have proven to be inaccurate, such as Democrats being best for the economy (not always), the Energy sector performing best under Republicans (not recently), and tax hikes causing negative equity performance (not in the post-World War II era).

This year has taught us a number of lessons, and expecting the unexpected is certainly one of them. While we are aware of where the potential aforementioned potholes may be, investors must take safety precautions as they advance toward their financial goals. Disciplined strategy and asset allocation parameters should serve as rumble strips, keeping a portfolio from drastically going off-course. In addition, an uncomfortable level of portfolio risk may be an opportune time to pull over and reassess the route ahead. Having your adviser serve as a co-pilot to help with directions is beneficial, but it is especially prudent when navigating the uncharted territory we find ourselves in today.

This upcoming quarter will move quickly—from the hopeful further reopening of the economy to the US Presidential election and the holiday season that follows. Above all, we wish you and your family health and prosperity in the final months of 2020.

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Chief Investment Officer, Private Client Group

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Trade, Disputes and November's Election

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

> "Controversial disputes are a part of democratic culture" – Angela Merkel

Before the pandemic hit, November's US presidential election was set to be this year's biggest geopolitical event on the minds of all global investors. This deep interest in the outcome of the US democratic process is both realistic and pragmatic. Realism is centred on the continuing deep economic, trade and diplomatic ties built up by all major economic blocs with the United States over the last couple of centuries. Pragmatism is focused on which way the result swings.

Given the relatively open nature of European economies, the question of trade disputes does not sit well with an audience in London, Paris or Berlin. Whilst Europe is currently struggling with its own internal Brexit challenges, as a region, it is acutely aware of the threat to its own economic prospects from a distinct falling out. However, it is not as simple as Europe preferring the candidate offering greater external trade stability. Europe itself has ambitions beyond its own regional borders and whilst the region is being aggressively courted by China, who sees a deeper partnership as making geographic, diplomatic, and economic sense, there is a grave suspicion of a country that operates a distinctly different political system and with potentially some highly differentiated views on issues such as human rights and local autonomy in Hong Kong.

These tensions cut across Europe's own regional schism, as shown by the far from unified reaction within Europe to the current administration's call to prohibit certain Chinese technology infrastructure companies from next generation telecommunications networks. Expect the UK – newly liberated from the European Union – to find reasons to make agreements with the next US administration more easily and quickly than the other major European countries.

In short, Europe is looking for the next four years to offer an opportunity to forge a partnership to build both democracy and accountability more deeply into global supranational organisations, whilst avoiding a generalised trade conflict. With issues such as a proposed European digital services tax on large (predominately) US technology names already causing conflict, you can see why the current crop of European political leaders are keeping their cards close to their chests. To say Europe awaits the result in November with great interest would be an understatement.

As for China, it would be simplistic to believe that the rhetorical flourishes that have characterised interactions with the United States over the last few years is the only level the two countries work with each other at. January's trade deal showed that the two economic superpowers can reach an agreement but the challenges to this remains legion.

Naturally, part of this is the longer-term game of two superpowers bumping up against each other, but do not think that China's preference is simply the presidential candidate who would be less oppressive on relations with the Middle Kingdom on a trade and diplomatic basis. China has economically matured from the mercantilist focused country of the 1990s and early 2000s, which prioritised a benign external environment in order to build wealth and power via a trade surplus. However, the China of the 2020s is economically stronger and hence less afraid of a fight. And a single party state which emphasises stability will be even more focused on the twin objectives of domestic economic development and a burgeoning external power. There are few better ways when communicating to a domestic audience about power by outfoxing an overtly critical opponent.

I would class China's interest in the upcoming presidential election as effectively feigned indifference. Tactics will adjust accordingly depending not only on who wins, but how policies that emanated out of America evolve.

Where the world after the US election becomes particularly interesting if the resident of the White House for the next four year presidential term, forges a closer relationship with both Europe and other influential global powers to push back against China on both trade and non-trade matters. Alternatively, greater disorder may become more of a norm. Even though an American electorate will choose the next president, the pushes and pulls on the winning candidate will be domestic and international in nature.

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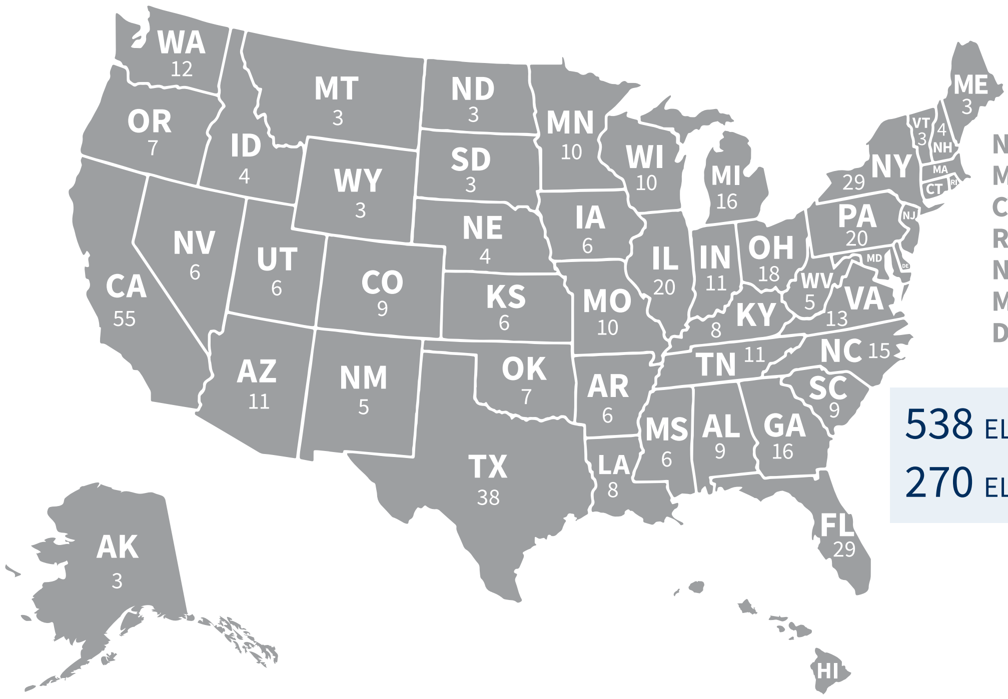
The Electoral Process Explained

- Each state appoints a **Number of Electors** equal to the whole **Number of Senators** and **Representatives** in the state.
- All states, except for Maine and Nebraska (who follow a district-level system), follow a 'winner-takes-all' approach to delegating electoral votes.
- Electors are not consistently legally bound to a given candidate and some have been 'faithless' in the past. A recent Supreme Court decision supported state laws that remove and replace electors voting in a different manner than their state popular vote, limiting the extent to which faithless electors could likely influence the election outcome.
- State legislators have broad powers over the elector selection process and the associated time-lines. Technically, it would be legal for legislatures to appoint electors that diverge from their state's popular vote winner.



NH	3
MA	11
CT	7
RI	4
NJ	14
MD	10
DE	3

All states, expect for Maine and Nebraska (who follow a district-level system), follow a 'winner-take-all' approach to delegating electoral votes.

538 ELECTORAL TOTAL VOTES

270 ELECTORAL VOTES NEEDED TO WIN

Congress has the authority to determine the time that Electors are appointed and the date that Electors cast their votes. ***This date is to be consistent across the United States.***

DECEMBER 8
Current state-level statutes require their state to resolve disputes at least six days prior to when Electors meet and cast votes. In some instances, officeholders have sent two electoral slates to Washington, DC for adjudication.

DECEMBER 14
The current statute states that votes should be cast on the first Monday after the second Wednesday in December.

DECEMBER 23
Another aspect of the current statute requires votes to be submitted to Congress by the fourth Wednesday in December.

JANUARY 6
If electoral votes are not received by Congress by the fourth Wednesday, the President of the Senate or the Archivist of the US are allowed to use "the most expeditious method available" to deliver votes to Congress. These votes are counted by Congress at 1 pm on January 6, 2021.

Sources: ConstitutionCenter.org, Congressional Research Service, Archives.gov, GovExec.com, Raymond James Research

Race for the White House: The Home Stretch

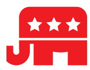
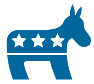
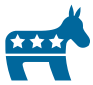
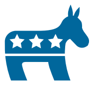
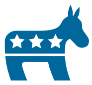
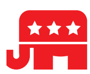
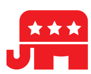
Ed Mills, *Managing Director,* Washington Policy Analyst, Equity Research

We often receive questions about the impact of elections on the stock market. In reviewing the historical analysis, we have seen periods where election outcomes have caused short-term volatility, but more importantly, we see that this volatility generally quickly corrects itself. We track what is going on in Washington because it can have extremely important market implications, from both a macro and sector-specific outcome, but above all, we always remind investors to not overreact to near-term swings in the market created by Washington activity.

As it relates to electoral outcomes, I know this can be an intensely debated topic, so we will leave that for voters to decide. However, we will address what each of the most likely post-election scenarios mean from a policy agenda and what impact they may have on the market. Additionally, we want to cover some of our bases with some potential 'curve-ball' scenarios (remember this is 2020 after all).

> The ability to enact a legislative agenda is correlated to who holds a majority in the House and Senate.

We view the following outcomes as the most likely composition of government post-election:

	Democratic Sweep	Status Quo	Divided Government
White House			
House of Representatives			
Senate			

As we think about the potential impact on the markets, we believe it is extremely important to avoid overly broad or sweeping conclusions and have a discussion of what might be different this year versus previous elections. Any discussion of the election has to recognise how important DC has been to the markets since the outbreak of COVID-19. We are in the middle of the largest fiscal and monetary experiment in the history of the world. The economic recovery and market reaction will be tied to the health aspects of the pandemic, and also to how much additional support is provided by Congress (fiscal) and the Federal Reserve (monetary). Finally, we will be paying close attention to the makeup of Congress, as the ability to enact a legislative agenda is correlated to who holds a majority in the House and Senate.

> "...election outcomes have caused short-term volatility, but more importantly, we see that this volatility generally quickly corrects itself."

RISK FACTORS TO WATCH

As 2020 has proven to be an extremely unusual year, we see some potential 'curve-ball' scenarios that are worth keeping an eye on as we get closer to Election Day. The 'curve-ball' outcomes we are most focused on include:

1. A delay in determining the winner of the presidential or key congressional races
2. The impact of third party candidates, and
3. A potential 'contingent election' if the Electoral College fails to determine a winner.

IMPACT OF THIRD PARTY CANDIDATES

In 2016, the margin of third party votes outpaced the difference between Donald Trump and Hillary Clinton in key swing states. In fact, almost 30% of the Electoral College vote went to a candidate who did not reach a majority in a state. Arizona, Florida, Michigan, North Carolina, Pennsylvania, and Wisconsin all make our list as 'toss-up' states. One underappreciated trait all six of these states have in common is that they were all won by President Trump in 2016, but all with less than 50% of the vote. Will the lack of a viable third party candidate in these states create a ceiling for Donald Trump as he seeks re-election? The same can be said for Minnesota, which is rated as lean Democrat, but was a state won by Hillary Clinton in 2016 with less than 50% of the vote. President Trump has been investing heavily in the state to see if he can move it into his column in November.

VOTING DELAYS AND IMPACT ON OUTCOMES

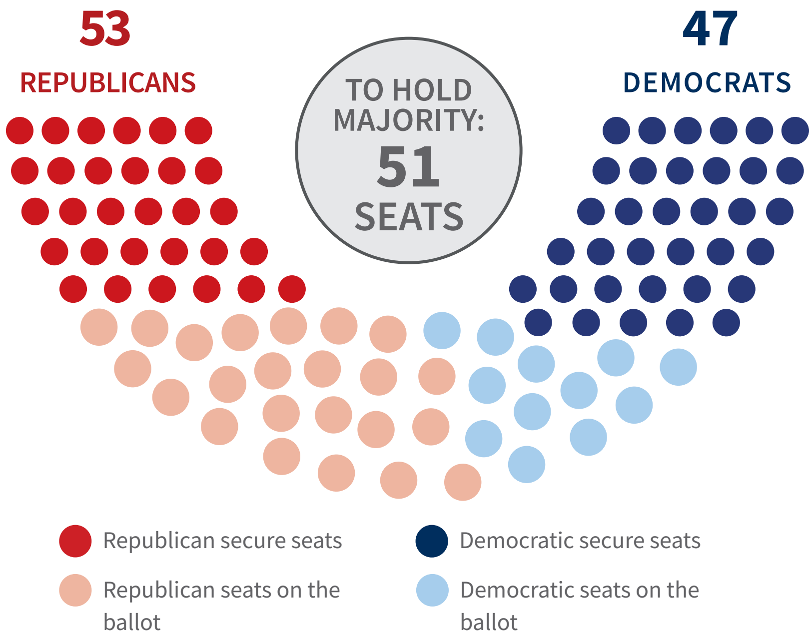
Five states are conducting elections entirely by mail-in ballot and 28 states and DC are offering no-excuse absentee voting. Polls suggest a substantially larger portion of Democratic voters intend to vote by mail in the 2020 election relative to Republican voters. One recent poll found that 80% of Republican voters planned to vote in person, with Democrats about evenly split between voting in person at 50% and voting by mail at 50%. There is also anticipation that turnout could be significantly higher this year, potentially overwhelming some precincts. Vote counting rules vary by jurisdiction, but for those who count and report day-of vote totals before mail-in votes, we could see significant swings between initial vote totals and the final vote. This could lead to confusion and increase the chance that some voters (and candidates) may not accept the final outcomes as valid, potentially triggering legal challenges or delays. After higher-than-normal rejection rates of mail-in ballots during the New York primary this year, we will be watching to see if the number of rejected ballots exceeds the margin in any state or Congressional race. The bottom line is that it could be well past election night before a winner is declared. In this scenario, we expect investors to adopt a risk-off approach to the market, i.e., tend to engage in lower-risk investments.

CONTINGENT ELECTION

An Electoral College tie (a realistic, although low-likelihood scenario) or the inability of the Electoral College to determine a winner triggers constitutional procedures and elevates the importance of the House election results. In a contingent election, the newly-elected House votes to select the president and the newly-elected Senate votes to select the vice president. The twist is each state delegation in the House casts a single vote, with a 26 vote majority (out of 50 state delegations) required to elect the president. Republicans are the majority in 26 state delegations in the current Congress, but Democrats flipping just seven key Republican seats could win them back the majority (among state delegations). If the House cannot select a president, the Senate-selected vice president will serve as acting

A Swing in the Senate?

With more than one-third of Senate seats on the ballot, will the Democrats swing party control or will Republicans maintain the majority?



Most Competitive Races

Alabama
Arizona
Colorado
Georgia (2)
Iowa
Kansas
Maine
Michigan
Montana
North Carolina
South Carolina

president until a president is chosen. If neither chamber is able to select their choice, the presidency is transferred by the constitutional order of succession. This scenario could produce surprise outcomes such as a split party president/vp; or an acting president Mike Pence, Nancy Pelosi (D-CA), Chuck Grassley (R-IA), or Patrick Leahy (D-VT). Again, this is a very remote possibility – but it is important to know procedures in a year that's shown volatility and uncertainty can quickly become the dominant theme.

THE BATTLE FOR THE SENATE

Policy in the next presidential term will run through the Senate. As such, markets will be closely watching the outcome of key Senate races for their potential to swing party control of the Senate to Democrats for the first time since 2014. In a Democratic sweep, we will be debating the market impact of the anticipated additional fiscal support for the economy vs. the increased probability of tax changes. Discussion on the potential elimination of the filibuster (lowering the threshold from 60 votes to a simple majority to pass legislation) would have a significant impact on what type of legislative agenda could occur in a Democratic sweep. Confirmations of key cabinet positions, judges, and regulatory agencies will also be closely examined to determine the direction of policymaking.

There are 35 Senate seats on the ballot this fall, with Republicans defending 23 seats and Democrats 12. Republicans currently hold a three seat majority, 53-47. In tracking Senate races over the last two years, race ratings since the beginning of the election cycle show that Democrats have expanded the playing field and are viewed as being competitive in more states than initially anticipated. We will have to wait and see if that translates into victories, and potentially a Senate majority on November 3.

A key factor to keep in mind is the impact of the national presidential race on individual Senate races. In the current politically polarised environment, 'ticket splitting' in which voters make different party choices down-ballot is largely dead. In the 2016 election, state Senate races matched the state's presidential preference in all cases for the first time in history – a trend likely to continue in 2020. If this trend continues, a Biden presidency has a decent likelihood of producing a Democratic majority in the Senate. A second term for President Trump, however, would likely retain a Republican majority and preserve the current makeup of government.

CONTROL OF THE SENATE: THE PATH TO A DEMOCRATIC MAJORITY

Democrats currently hold 47 seats in the Senate, and 12 of these seats are up for election in the current cycle. We consider two of the 12 as the most likely to switch parties, with Democratic incumbent Doug Jones (D-AL) as the most vulnerable Democrat (President Trump won AL in 2016 by almost 28 points). Republicans are defending 23 seats, with seven seats currently rated as most likely to switch parties. If Democrats lose the Senate seat in Alabama, the path for Democrats to retake control of the Senate runs through four main states to hit the 50 seat threshold (the vice president would cast the tie-breaking 51st vote in a Democratic administration): Arizona, Colorado, Maine, and North Carolina. The next most competitive races include Georgia (two seats), Iowa, Kansas, Montana, and South Carolina. Other seats in both parties are competitive and could switch parties in November, but for this article we are focused on the 'most likely' path for either party to win, or retain, a majority.

DEMOCRATS FAVOURED TO RETAIN HOUSE MAJORITY

Race-by-race analysis and polling data favours Democrats to retain the majority in the House of Representatives this fall. Democrats built a sizable majority in the 2018 midterm elections, and current political trends support a continuation of the dynamics that boosted Democrats in the midterms. Democrats are currently favoured by a notable margin in the 'generic ballot' test, traditionally the best indicator for the overall House result. An approximate seven point lead in the generic ballot produced a 40 seat Democratic gain in 2018, and Democrats are favoured by a similar margin in this cycle. Democrats go into the 2020 cycle with a 207 seat base projection compared to 172 for Republicans. There are 56 seats rated as competitive, and 28 rated as too close to call (toss-up seats). In order for Republicans to win back the majority, they would have to win all 28 toss up seats, and gain three upset victories in Democrat-favoured seats – a significant uphill battle.

IN SHORT, EXPECT UNCERTAINTY

To conclude, we expect volatility around the election to continue the historical trend of a cautious market approach leading up to November. The nature of our election process this year, from start to finish, will be unlike any in recent memory. Razor thin margin swings could produce widely divergent outcomes, while vote count delays could stretch Election Night into Election Weeks/Months. Historically, this volatility quickly corrects itself as the result settles. A presidential race in an uncertain and unpredictable year is proving to be no exception to the trend, but as we frequently say about DC market impacts: the ultimate outcome is never as good as you hope, or as bad as you fear.

KEY TAKEAWAYS:

- Election outcomes typically cause short-term volatility, but we see that this volatility generally quickly corrects itself.
- We believe it is extremely important to avoid overly broad or sweeping conclusions and have a discussion of what might be different this year versus previous elections.
- The 'curve-ball' outcomes we are most focused on include: a delay in determining the winner of the presidential or key congressional races, the impact of third party candidates, and a potential 'contingent election' if the Electoral College fails to determine a winner.
- We expect volatility around the election to continue the historical trend of a cautious market approach leading up to November. The nature of our election process this year, from start to finish, will be unlike any in recent memory.

Economic Outlook: Through the Pandemic and Beyond November

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

Many factors feed into the relative strength or weakness of the US economy, but the president traditionally receives the credit or blame. Fiscal policy – taxes and government spending – have an important role in economic activity, and confidence can drive consumer spending and business investment decisions. However, Congress controls the purse strings. The president does not have the ability to fine tune the economy, but whoever wins the White House will face a number of challenges in dealing with an ongoing pandemic and record levels of government borrowing and spending.

THE FEDERAL BUDGET DEFICIT

The cornerstone of the Trump administration's economic program was the Tax Cuts and Jobs Act of 2017 (TCJA), which lowered the capital gains tax rate and reduced federal tax rates for most households and businesses, but also restricted deductions. The drop in the capital gains tax rate was meant to spur capital spending, but business borrowing costs were already low and firms were already generally flush with cash before it was signed into law. While some households paid less in taxes, the reduction in deductions meant that others paid more. GDP growth in the first three years under Trump was not much different than in the final four years under Obama. TCJA added substantially to the federal budget deficit, which exceeded $1 trillion in the 12 months prior to the pandemic.

Fiscal support to address the impact of extreme social distancing added further to the deficit, bringing the 12-month total to nearly $3 trillion in August. In any downturn, fiscal policy can play an important role in reducing the damage. Without it, temporary impacts can lead to more permanent damage. Businesses fail. Workers lose job skills. However, in applying fiscal support, there are always questions of how big it should be and how long it should last. Ideally, the degree and timing of support should depend on measures of job distress, such as the unemployment rate. However, lawmakers have not been able to agree on that.

While the increase in government borrowing is worrisome to many, the real danger is not doing enough to support the economy in the near term and ending support too soon. The government is nothing like a household. The federal debt does not need to be paid off. The government has no problem borrowing. However, the federal budget was on an unsustainable track before the pandemic. The national debt was rising faster than nominal GDP. To get back on a sustainable trajectory, with debt rising no faster than GDP, we'll need more tax revenue or less spending. These will be difficult choices. Prior to the COVID-19 pandemic, non-defence discretionary spending (which excludes Social Security, Medicare, defence, and interest rates) was just 2.8% of GDP.

FACTORS OF THE RECOVERY

> What happens in 2021 depends on more than who wins the White House.

What happens in 2021 depends on more than who wins the White House. During the Clinton years, a divided government led to a budget surplus. Republicans didn't get big tax cuts. Democrats didn't get big spending increases. In contrast, in the current situation, a divided government makes it harder to get things done. One party rule (the same party controlling the White House and both chambers of Congress) will most likely lead to higher taxes or cuts to entitlement programs, depending on the outcome.

The Federal Reserve will continue to do its part beyond November, keeping short-term interest rates low, through 2023. The Fed's recent changes to its stated policy objectives had already been underway in practice over the last couple of years. Specifically, the adoption of a flexible average inflation targeting framework means that policymakers will allow inflation to exceed the 2% goal following a period of inflation below 2%, but this will not be done in a mechanical way. Judgement will drive policy decisions.

The Fed's employment goal has been made broad-based and inclusive. In a break from the past, the Fed will no longer raise short-term interest rates pre-emptively to fight inflation when the unemployment rate is low. There is no specific target for the unemployment rate, as officials recognise that low unemployment substantially benefits low- and medium-income communities.

The pandemic now appears likely to be a more long-lasting economic event, requiring a restructuring of significant parts of the economy over the quarters ahead – and elevated job losses remain a key risk. While the Fed has been critical in providing liquidity, it can't offset the economic impact of an ongoing pandemic. Further fiscal support will be needed, regardless of the November outcome.

> "While the increase in government borrowing is worrisome to many, the real danger is not doing enough to support the economy in the near term and ending support too soon."

Federal Debt Held by the Public, 1900 to 2050

Source: Raymond James Investment Strategy
All expressions of opinion reflect the judgment of the author and are subject to change. Past performance may not be indicative of future results.

Japan: new Prime Minister, new opportunities?

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

> "Living in Europe, I was surprised to find out just how little everyone knows about Japan" – Hidetoshi Nakata

For many years one of the jokes in international investment circles was 'who is the Japanese prime minister this month?' However, after over eight years of 'Abenomics' under the now retired Shinzo Abe, a very reasonable question today is whether the ascension of new prime minister Yoshihide Suga marks an effective continuation or hints of potential of a regime shift.

Scarred by prior interactions or distracted by new opportunities, many investors forget about the Japanese market which consistently over recent years has maintained an 'undervalued but underowned' in the world's biggest regular fund management survey. For an economy which remains the second largest in Asia and which still sports the third largest global equity market, this feels like a potential oversight.

Part of this is due to 'Abenomics' never really hitting its full potential, as despite loose monetary and fiscal policy implemented respectively by the Bank of Japan and the Ministry of Finance along with some structural reforms designed to cope with a fast-aging population, restructuring the banking sector, rejuvenating the backdrop for smaller businesses, and updating Japanese production chains.

Suga is patently a continuation candidate from the perspective of being an integral part of Abe's team during the latter's prime ministerial period. And from a practical policy perspective, the newly announced record national budget for fiscal 2021 of 105 trillion yen (almost one trillion dollars equivalent) along with a potential supplementary budget in the current fiscal year, is a nod towards continued policy largesse. Similarly Bank of Japan pronouncements have been very much at a 'business as usual' level, reflecting not an institutional independence but rather a continuing full adherence to forging a commingled joint policy front with the government.

> At the centre of next year's national budget is a digitisation of government services

However, some changes are coming. At the centre of next year's national budget is a digitisation of government services push inspired - apparently - by Japan's drop in the United Nations' e-government development ranking to fourteenth place for this year.

Technology matters for Japan as any visitor to the country will attest. Whilst other countries grapple with their potential demographic time bomb by supplementing extended working lives with immigration, Japan has to date preferred to combine Abenomics initiatives such as greater adult female labour force participation with significant robotisation. For this policy to not be supplemented by a significant digitisation push is a national embarrassment and an unsurprising policy for the fledgling Suga government to pursue.

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This feeling of slightly slipping behind the curve is a common one for those looking at the Japanese economy from outside. For all its global creative influences over time, the 21st century has been more influenced by other Asian powers such as South Korea and - inevitably - China.

However, at least at a corporate level Japan does still have a few cards to play. Helpfully during the ongoing pandemic, the high average cash positions have provided a buffer and there have been some minor signs of improving shareholder corporate governance. And whilst Japan was the originator of the 'zombie company' concept - generally defined as companies which without banking sector support would be insolvent as they struggle to cover their interest payments - this is a growing concern in economies all around the world.

Japan feels like a financial market that individual stock selectors can especially add value in. Certainly Warren Buffett's recent investments in the country captured a few headlines and should inspire others. But whilst such bottom-up instincts and actions may prove opportunistic, do not be lulled into thinking the broader 'top-down' picture is particularly evolving. Akin to the pan-European markets, the composition of the Japanese bourse is quite cyclical / value centred and would disproportionately benefit from a general global recovery from the pandemic. Global perception will also be aided by a successful hosting of the Olympics which currently are still set to be hosted next summer following the pandemic-induced postponement.

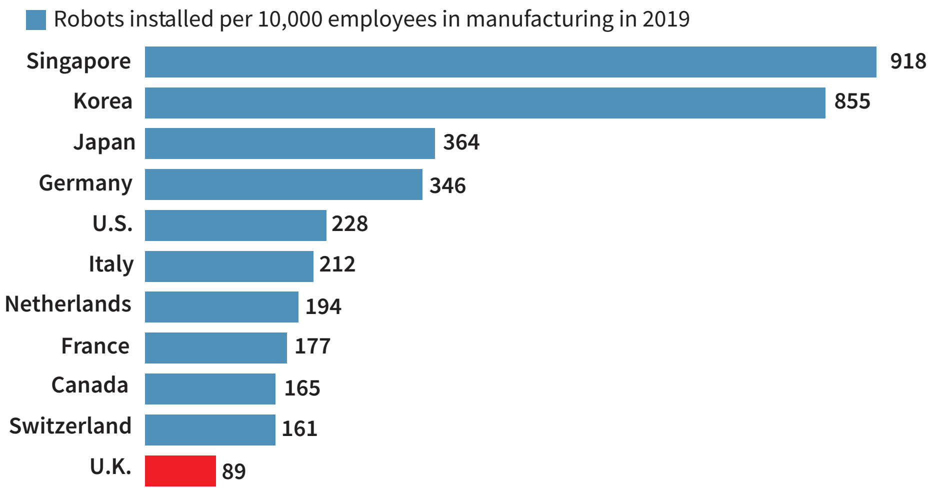
Meanwhile 'Suganomics' is likely to be a continuation series of policies with an initial focus on securing a longer political term via a general election in the next year (and possibly much sooner) as opposition parties appear very fragmented. So, exciting times potentially for political watchers, if less so for economic or financial market ones. But this does not mean the Japanese market is not of interest for investors. Being active can always carry its own rewards.

KEY TAKEAWAYS:

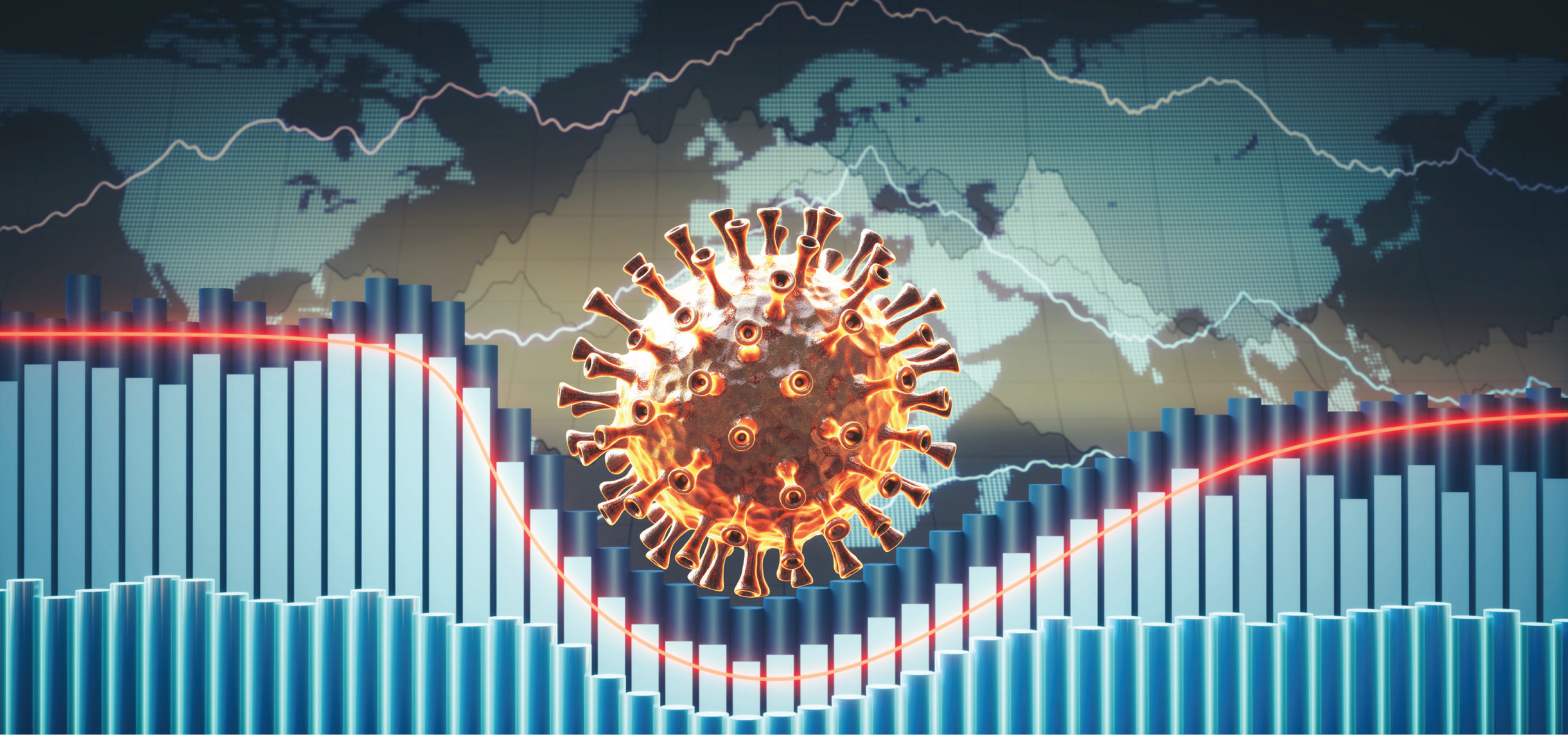
- Yoshihide Suga recently took over as the Japanese prime minister from the long-serving Shinzo Abe
- Monetary and fiscal policy initiatives appear unlikely to particularly change
- The Japanese market which consistently over recent years has maintained an 'undervalued but underowned' in the world's biggest regular fund management survey
- Japan feels like a financial market that individual stock selectors can especially add value in

Robots installed per 10,000 employees in manufacturing businesses in 2019

The U.K. has the lowest robot density among leading economies



Source: International Federation of Robotics



COVID-19 360°: An Update

Chris Meekins, Director, Healthcare Policy Analyst, Equity Research

COVID-19 has wreaked havoc on both physical and economic health in the US. For those who have lost loved ones, the pain is very personal and real. Many of those individuals may feel as though government leaders have failed them. For those who have lost jobs as a result of the shut-downs and those who are struggling to pay for a roof over their heads or food for their families, the pain is very personal and real as well. Unlike many prior crises, the nation has not become unified in combating this crisis. Politicians have taken very different approaches and we are seeing views on how to combat the virus fall along party lines. These divisions will likely continue to hinder our ability as a nation to most effectively combat this crisis.

> “As individuals return to school, work, and other activities this fall, the race for a vaccine becomes particularly important.”

> We have seen notable improvements in the fatality rate from the virus as time has passed.

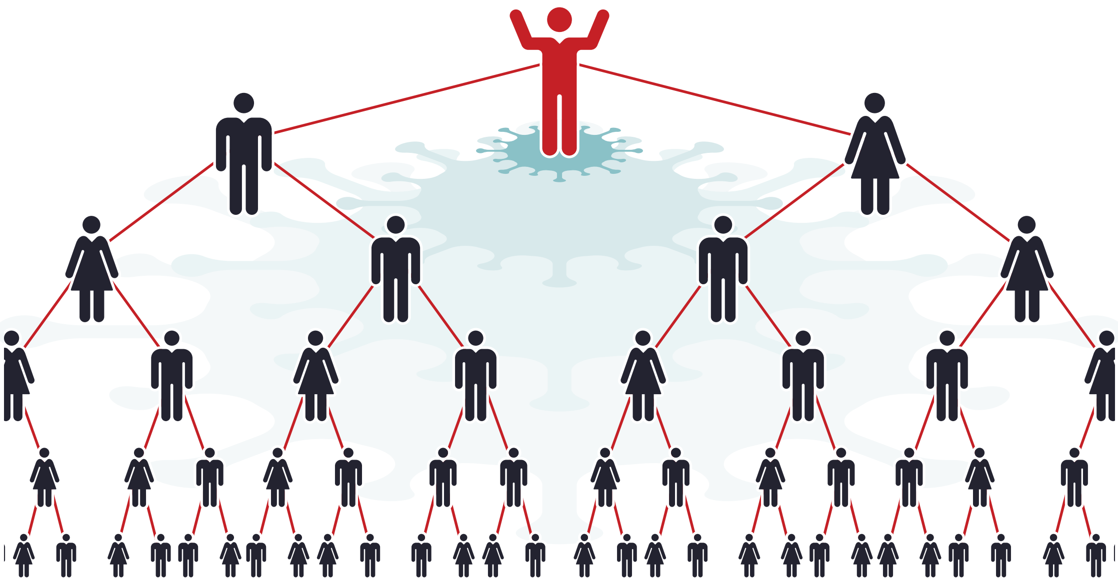
CONDITIONS IMPROVING, HOWEVER, CRISIS REMAINS

With over seven point five million identified cases, over 200,000 identified deaths, and likely many more asymptomatic or otherwise undocumented cases, we have shown a capacity to flatten the curve as a country. We have also seen what can happen when mitigation measures are ignored, with the secondary outbreaks in places like Arizona, Florida, and Texas that are just now getting back under control. The reality remains that as mitigation measures are loosened – when people stop wearing masks and start congregating in large gatherings – we will likely continue to see surges in cases in different states and regions until we reach herd immunity through infection or a vaccine. Public health leaders will have to continue to play ‘Whack-a-Mole’ as new hot spots emerge.

We have seen notable improvements in the fatality rate from the virus as time has passed. This is likely a result of doing a better job protecting those most vulnerable (such as those in nursing homes) and improvements in care protocols for those who are hospitalised. As time passes with every disease, improvements occur in the way individuals are treated as great scientific understanding is achieved. Some treatments,

Contagious COVID

Asymptomatic carriers, diverging opinions, and the ease of transmission make the spread of COVID-19 difficult to control.



like convalescent plasma, are showing promise, but we still do not have a 'cure' for the virus.

After struggling in the early days with testing, the US has now completed nearly 100 million tests. New advancements in rapid tests have the potential to dramatically increase testing levels yet again. If these tests become broadly available, we could see increases in the comfort level of individuals to fly, attend large gatherings, and participate in other public group activities.

The decision of whether to open schools, remain entirely virtual, or some hybrid approach during the school year is one of the most challenging and divisive for those influencing the decisions. This decision is particularly complicated given the ramifications of 1) not opening schools, and consequently depriving many students of social support, school-provided supplies, sponsored meal programs, and school-provided accommodations; versus 2) reopening schools, and potentially causing an outbreak of the deadly coronavirus among communities, children, families, teachers, and the broader US. Fortunately, according to the latest information from the Centers for Disease Control and Prevention (CDC), children are at relatively low risk of experiencing severe side effects; however, they can spread the virus to others. For most states, the decision to reopen is left to local school jurisdictions and local health authorities. Only Texas, Florida, Iowa, Missouri, and Arkansas have required in-person education to be available. On the other hand, Vermont, Rhode Island, West Virginia, DC, New Mexico, and Puerto Rico have orders banning all in-person instruction. Although some schools have reported case spread, the full impacts of schools reopening has yet to be seen. We anticipate that schools that have chosen to reopen will likely switch to online if virus spread surges.

THE RACE FOR A VACCINE

As individuals return to school, work, and other activities this fall, the race for a vaccine becomes particularly important. On the vaccine front, several candidates show strong potential. According to Raymond James Biotechnology Analyst Steven Seedhouse, leading vaccines are being tested from companies and institutions such as AstraZeneca/University of Oxford, BioNtech/Pfizer, Inovio Pharmaceuticals, Johnson & Johnson, Merck, Moderna, Novavax and Sanofi/GSK. China and Russia have granted limited approval to vaccines without conclusive results on their efficacy. The Trump Administration's Operation Warp Speed (OWS) is the coordinated government effort one would expect in a time of crisis. OWS has funded multiple vaccine candidates and is working to ensure the US has hundreds of millions of doses available in 2021. Analysis of new data on vaccines continues and it is possible that an emergency use authorization (EUA), which is not the same as full approval, could be given by the Food and Drug Administration (FDA) for a vaccine prior to the end of 2020 and possibly before the election.

President Trump and his campaign team are pushing hard to get an EUA for a vaccine before election day. The FDA continues to push back against accusations that they may prematurely approve vaccines or therapeutics due to political pressure from the Trump Administration. The Trump campaign believes that getting a vaccine before the election could move undecided voters to him. One challenge is the number of people who are either sceptical of, or will refuse to get, the vaccine.

IMPACT ON THE ELECTION

COVID-19 is likely to impact the election in other ways. For example, if we see a major up-tick in cases right before the election it could urge voters to want new leadership. Additionally,

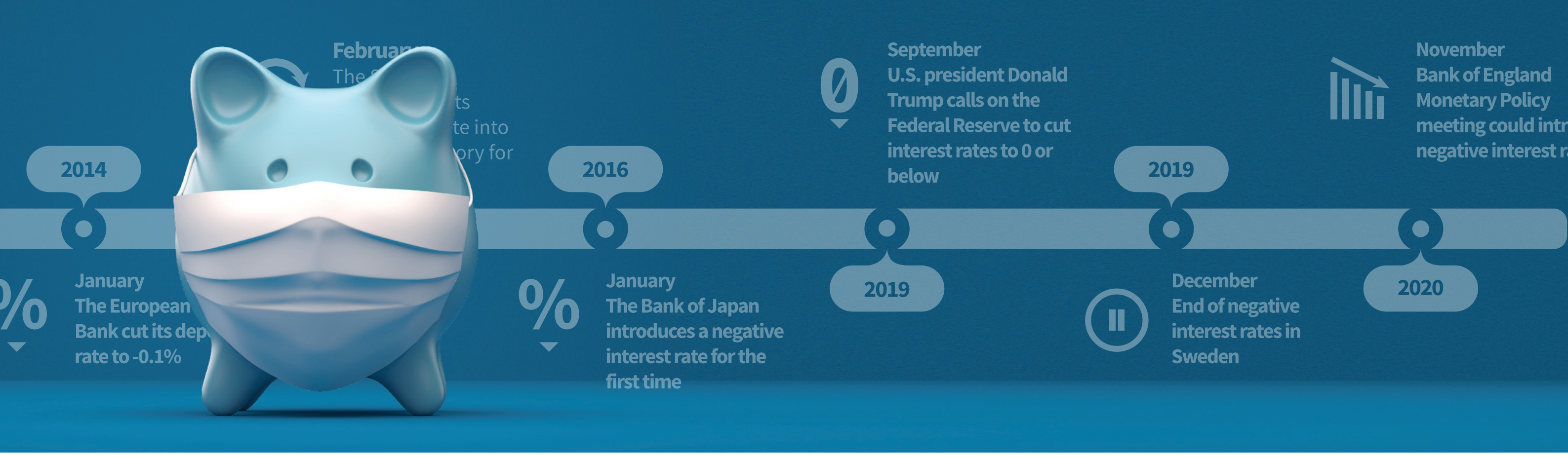
The impact of the pandemic is likely to continue to impact nearly every area of our lives from educating children, to what travel we partake in, to how we chose to vote, and even the outcome of the upcoming election.

the logistics of voting in the COVID-19 era and the complications of potentially delayed results could have an impact. While elections can allow for social distancing in lines and in polling centres, fears and inconveniences of voting could result in only the most enthusiastic voters showing up at the polls. Recent polling shows a majority of Republicans plan to vote in person, but a majority of Democrats plan to vote by mail. As a result, we could have one candidate's supporters believe that their candidate has won on election night, only to find out the other candidate won once all the votes are counted. Accusations of voter fraud will likely run rampant, creating uncertainty for the markets.

The bottom line is this: COVID-19 will remain an issue until we reach herd immunity or a vaccine that is widely used arrives. The impact of the pandemic is likely to continue to impact nearly every area of our lives from educating children, to what travel we partake in, to how we chose to vote, and even the outcome of the upcoming election.

KEY TAKEAWAYS:

- Unlike many prior crises, the nation has not become unified in combating this crisis. These divisions will likely continue to hinder our ability as a nation to most effectively combat this crisis.
- We have shown a capacity to flatten the curve as a country. Given behaviors, we will likely continue to see surges in cases in different states and regions until we reach herd immunity through infection or a vaccine. Public health leaders will have to continue to play 'Whack-a-Mole' as new hot spots emerge.
- If tests become broadly available, we could see increases in the comfort level of individuals to fly, attend large gatherings, and participate in other public group activities.
- Analysis of new data on vaccines continues and it is possible that an emergency use authorization (EUA), which is not the same as full approval, could be given by the Food and Drug Administration (FDA) for a vaccine prior to the end of 2020 and possibly before the election.



Negative interest rates: desirable or likely?

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

> “Always turn a negative situation into a positive situation” – Michael Jordan

Negative interest rates provide an obvious challenge for the financial system as even a mild introduction of the concept of borrowers being paid on their lending balances or depositors being charged for maintaining money in the bank, appears to completely invert norms. With the Bank of England publicly flirting with the idea, are negative interest rates in the UK either desirable or likely?

Negative interest rates reflect an outer boundary of monetary policy, even more extreme than quantitative easing (QE) or other policies centred on the extreme printing of money, which have periodically blighted national treasuries since Roman times. They have been embraced by the Bank of Japan and more famously by the European Central Bank (ECB), with the latter justifying them as part of their ‘whatever it takes’ toolkit to help boost the regional economy. However, six years after their implementation by the then ECB President Mario Draghi, Eurozone economic activity and inflation levels remain muted even with the juxtaposed application of QE and other policy measures.

As a policy instrument, negative interest rates do not appear to be any form of an economic panacea.

As a policy instrument, negative interest rates do not appear to be any form of an economic panacea.

To understand why this might be, a little bit of economic theory combined with business practicality can go a long way. The way lower interest rates can stimulate an economy is pretty straightforward to see as lowered interest costs for borrowers and reduced discount rate hurdles for investors, stimulate activity. Part of this transmission mechanism is the banking system itself with the money multiplier impact (how an initial deposit can lead to a bigger final increase in the total money supply) being boosted by the aforementioned lower interest rates. And clearly the reverse is true for higher interest rates.

So why should negative interest rates not be just an extremely loose and stimulating version of the above? Well broadly speaking the above rests on borrowers, lenders and investors acting in a theoretically logical manner. However, all these groups are impacted by broader psychological factors too. Just as an ordinary person may regard something as ‘too good to be true’, extremely low or negative interest rates can induce a similar reaction.

A quote often attributed to the great economist John Maynard Keynes was that using monetary policy to fight a severe recession is like ‘pushing on a piece of string’. Even before the impacts of the pandemic, both Japan and the Eurozone had faced a lengthy period of suppressed growth and lowered propensity of economic actors to act in a dynamic and risk-embracing fashion. This backdrop meant that negative interest rates were doomed not to have the impact policymakers would hope. Ironically instead of depositors shying

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away from putting their savings in the bank, deposits in countries including Japan and Germany went sharply up. This was also influenced by banks deciding that a generalised policy of charging depositors for maintaining a positive balance would have been foolhardy. Even with interest rates on mortgages and other financial products pulled down to negligible levels by the negative interest rate backdrop, many individual or corporate borrowers were reluctant to overtly borrow more given the difficulties they were seeing in their day-to-day economic lives over previous years. And caught between paying out positive depositor rates and lowered lending rates (and relatively stagnant lending volume growth), the banking system could not offer up a strongly positive money multiplier. And naturally a weakened and defensive banking system can create its own problems. Net result? A negative interest rates policy has been far from as economically stimulating as hoped.

And the broader financial system has been impacted too. Fixed income investors have seen income levels substantially dwindle (although the capital value of their bond holdings have materially risen). Equity and investment banking markets have been buoyed by cheap money but such shifts can be laid at the door of QE per se than negative interest rates.

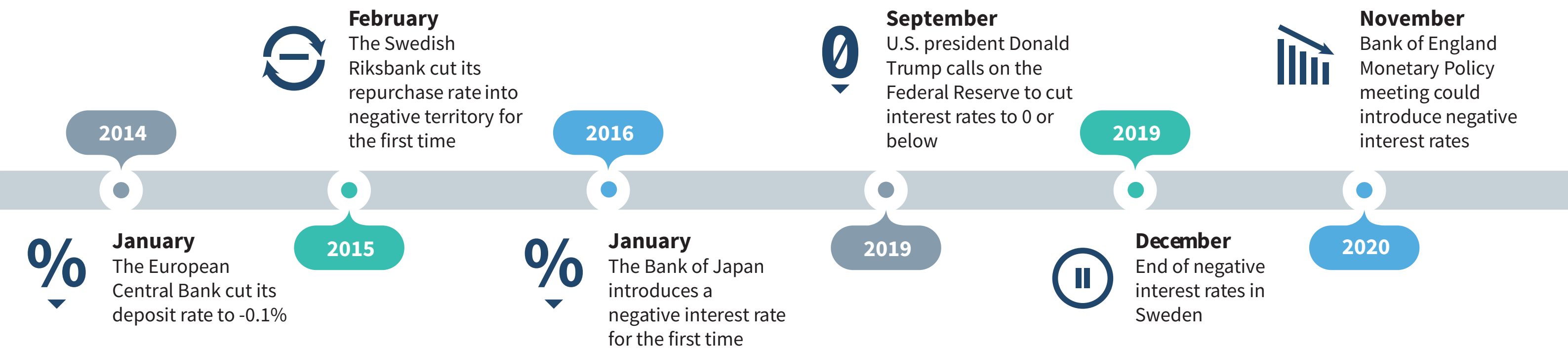
Some central banks have had enough. Many of the above reasons were behind the Swedish Riksbank reversing their own policy of negative interest rates last year - and offer a cautionary perspective for the current ongoing discussions at the Bank of England. Many commentators have cited the policy announcement due on the 5th November as the point where negative interest rates could be formally embraced. Guy Fawkes Day would seem appropriate timing for such monetary policy fireworks. From my perspective such a policy shift would be difficult to justify given recent practical experiences from akin central banks. Far better to augment the quantum of quantitative easing support, continue with aspects of government-led fiscal policy boosts along with an overarching range of productivity and dynamism enhancing supply-side measures to boost national competitiveness, confidence and entrepreneurial spirit.

Mathematically two negatives do make a positive but rather than combining a cautious backdrop with negative interest rates, encouraging positive thinking and risk preferences among consumer, industrialists and entrepreneurs is undoubtedly smarter.

KEY TAKEAWAYS:

- Negative interest rates provide an obvious challenge for the financial system but have been implemented by the Bank of Japan and European Central Bank
- They can struggle with the ‘too good to be true’ argument and induce strange responses from economic actors
- Practical examples show that a negative interest rates policy has been far from as economically stimulating as hoped
- Watch out for the 5th November Bank of England policy announcement for more insights

Negative interest rates over time



Source: Various Google searches by the author.

DISCLOSURE

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