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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer
Carrying the Torch

Athletes at the Olympic Winter Games will either taste the thrill of victory or the agony of defeat. The same can be said for investors, as the easy victories over the last two years will become more challenging and hard fought in the year ahead.

2021 was all about speed – the fastest economic recovery on record and a history-making equity market run. And while speed is important, winter Olympic champions have demonstrated that precise execution is equally as important, especially as they grapple with weather, equipment, and slippery surfaces. For the markets, execution will be centre stage – from the Federal Reserve's (Fed) and Bank of England's managing of monetary policy, to corporate CEOs' ability to maintain healthy margins, to OPEC's oil supply decisions. With elevated valuations for most asset classes, performance under pressure will be unrelenting. At times, the margin of error may be slimmer than that of a figure skater nailing a Triple Lutz. However, we are optimistic that the economy and financial markets are well-trained, have favourable fundamentals, and are set to carry the torch for positive investment returns. That is why despite some periods of tough sledding, we forecast another gold medal year for the markets and economy.*

As we anxiously prepare to watch the Winter Games, we felt the Olympics scored a 10 as a backdrop for our Ten Themes – so we prepared 10 captivating sports metaphors to accompany our views.

The U.S. and U.K. Economies are Ready to Take Off

The economy's view from the top of the ski jump ramp is a lot less scary now that effective vaccines are available. But what really propelled the 2021 results was the momentum from supportive fiscal and monetary policies. Now the economy is ready to take off and fly at an above-trend pace for the second consecutive year – but this time on its own, without policy support. In fact, this is the first time annual economic growth, in the US, will soar above 3.5% for back-to-back years since 2000! The emergence of variants may cause some resistance, but COVID's gradual transition from a pandemic to endemic state should be the biggest tailwind. Consumers will probably return to more normal lives. And with still elevated cash balances, services spending will lift off and join already resilient goods consumption to improve the aerodynamics of the recovery. Brisk capital expenditures and the steady rebuilding of inventories should also help the economic expansion go the distance.

The Fed and the Bank of England Must Adeptly Navigate the Fast-Moving Economy

Like a bobsled hurtling down its track, the global economy is racing to reopen, and pent-up demand is pushing inflation like the g-forces in a tight turn. The inflationary surge is also pushing the Fed into its next heat – tightening monetary policy. The Fed and BoE will be the brakeman, deciding if, and when, to slow the pace of growth to throttle back on inflation. We see the Fed steering in a less aggressive, more pragmatic manner than many expect, anticipating at least two well-telegraphed interest rate hikes, with the

> "When you're racing toward your investment goals, stick to your game plan and listen to coaching from your trusted adviser."

same expected in the UK, albeit from a lower level, that the market and economy will absorb like an expected bump in a bobsled run. The key question is what rate boosts will come in 2023, as this will have an impact on 2022 sentiment. We expect the rate of economic growth going downhill just enough to freeze inflationary pressures and grant the Fed the power of flexibility. While some observers talk of a potential yield curve inversion (where short-term rates move higher than longer-term rates), we think the Fed sled and the BoE's Bob will be driven conservatively, remaining patient and relatively accommodative.

Yields Will Swerve Between the Gates

Downhill skiers reach impressive speeds when weaving through gates on the mountainside. Although skiers are going faster and faster, the US 10-year Treasury yield has failed to reach its previous peak rate after each successive tightening cycle. This cycle will be no different. Structural factors like government debt, demographics, and globalisation trends should keep the 10-year Treasury yield zig zagging within a tightly gated range, ending the year around 1.9% in the US. The modest move higher is expected on both sides of the Atlantic as the Fed and BoE remove their emergency measure netting, making for a challenging run for fixed income returns. Despite this, bonds still play a critical role for investors who need to tuck away from equity risk. Periodic bouts of volatility could create opportunities in the corporate credit markets as the macroeconomic backdrop remains positive, with low default rates and improving corporate earnings.

The Democratic 'Blue Wave' is Skating on Thin Ice

Given the rough-and-ready rhetoric, ice hockey seems to be the right sport to describe the 2022 political scene. The perceived dysfunction in both DC and Westminster has not stopped the economy and financial markets from scoring in recent years. There have been scuffles between policymakers along the way, but they never let the puck stop in meeting the needs of the economy and the people. In the US the unprecedented $6 trillion in fiscal stimulus to not rolling back the Trump-era tax cuts, both parties have achieved top-shelf agenda items that stimulated the economy and supported equities. In the UK Mr Sunak's last budget was more about stimulating growth than paying for the last few years. US history suggests the incumbent party tends to lose seats in the House of Representatives in midterm elections, making gridlock the anticipated outcome. In the UK Boris's leadership is looking equally shaky. With politics in the neutral zone, few major policy shifts should make it off the boards. Market fans are likely to view this positively, as the economy has scored its share of goals and is no longer languishing in the penalty box.

Equities' Transition from Power and Speed to Targeted Precision

To win in biathlon, athletes must ski fast and shoot straight – two very different skills. The equity market excelled during the speed portion of the race, bullishly boosting equity valuations and notching a record rebound in earnings growth along its way. Now, the market is transitioning to a period where precision and steadiness are needed. Investors must become expert marksmen, aiming carefully at the right sectors and right companies. We have our sights set on more cyclical sectors, as their earnings should benefit from above-trend economic growth. Just as Olympic officials salt the course to turn slushy, slow snow into a super slick ice track, the continuation of shareholder-friendly actions and a still low interest rate environment will salt the course.

*Financial forecasts should NOT be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Expressions of opinion are as of this date and are subject to change. Past performance is not a guarantee or a predictor of future results.

Letter from the Chief Investment Officer *(cont.)*

Sector Exposure Will Steer Small Cap in the Right Direction

Luge competitors are the fastest of all Winter Games athletes, and the fact the sleds do not have brakes puts it among the riskiest of sports. The same could be said of small-cap equities, as they have faster earnings growth but a higher beta than large-cap equities. But unlike lugers who fly down the track on their backs, small-cap returns did not fall flat on their backs last year. However, they did not travel on the optimal line down the course. Given our economic growth expectations for this year, especially the uptick in services spending, small-cap equities should offer investors an edge. The asset class's shell of a sled is composed of some of our preferred cyclical areas of the economy (e.g., Industrials, Financials, Energy).

There are No 'Bindings' on Technological Re-Invention and Adoption

Many think of snowboarding as a quintessential winter sport, but it is still relatively new to the Olympics. Once, skiers were sceptical of its future, but its popularity has surged, and now there are courses around the globe. The pace of technological adoption has been similarly eager, with events such as the pandemic deepening our dependence on innovation. Just as the difficulty of the gravity-defying snowboarding stunts has increased, technology keeps reinventing itself, making revolutionary contributions to productivity. Like the demonstration sports in the Olympics, once fans try new technology, it becomes a permanent part of a business's performance. Just watch the development of the Metaverse, which is a young gun growth catalyst offering an online world with virtual reality, 3D holographic avatars, video, and other means of communications. Rookies like Metaverse are joining veteran catalysts such as cloud computing and 5G, pushing business plans for future tech spending to record levels. There's no limit to the stunts the sector can do, and its earnings power should continue to justify the seemingly lofty valuations.

Focusing On US Equities' Consistent Stride

In short track speed skating, victory margins are as thin as the blade and one small slip can lead to defeat. With the track measuring just over 100 meters, any athlete could win. Similarly, it is hard to pick a region as a short-term equity market winner given that varying supply chain bottlenecks, COVID surges, and differing policy responses are causing false starts. However, long-distance speed skaters, just like long-term investors, have more time and space to excel. Profitability ratios give the US the inside track versus other developed markets with the UK close behind, but the Asian emerging markets are gaining on us. Between attractive valuations, exposure to high-growth tech industries, and scope for additional stimulus, investors should think globally as the International Olympic Committee does.

Oil Prices Dynamics Will Find Their Balance

The energy market's performance in the recovery's routine has been anything but smooth, with COVID, inventory releases, and natural disasters causing oil prices to twist, turn, spin, and lift. However, supply and demand dynamics should find their balance and help oil prices avoid a fall. In past Olympics, Russian figure skating judges sometimes scored compatriot athletes too high and competitors too low. In the oil market, we still have a Russian judge and its OPEC fellow judges who are likely to continue to prop up the price. Therefore, we expect oil prices to remain around the figure eight(y) range. Prices at this level should no longer lead to deductions in the growing renewable energy space, and should instead, encourage the development of these markets.

Look Below the Surface for Opportunities

For sheer thrills, 2021 will be hard to beat! Between a blistering start to the equity bull market, healthy commodity gains, historically low interest rates, and the second smallest intra-year pullback since 2000, it is no wonder our forecasts don't have investors hanging on the edge of their seat. We can identify with curling players who barely get a blink of TV time compared to the skaters and skiers. Yet, under the surface, curling is so tactical and complex it's sometimes called chess on ice. Similarly, there's a lot going on below the surface, and there are plenty of opportunities to add value to a portfolio. The news headlines will still come sweeping in — COVID variants, Fed and BoE tightening, mid-term elections in the US, geopolitics — adding more or less friction to the markets. For this reason, active management and selectivity are prudent to avoid an investment year with a blank end (no team scores any points).

No Resting on Laurels as the New Year Begins

Like the start of any big race, embarking on 2022 is both exciting and daunting. We hope the resilient economy and record bull market will proudly *carry the torch* into 2022, but there's always the fear of a *tumble on the slippery slope*. We favour the mindset of Mikaela Shiffrin, who is seeking to become the most decorated alpine skier in American history: *"When I am in the starting gate, it's just me and the hill."* There will always be the *distraction of the crowd*, but when you're racing toward your investment goals, stick to your *game plan* and listen to coaching from your trusted advisor. And we hope that our views serve as a reliable, integral part of your plan, and that your portfolio reaches the *top of the podium.*

Again, we wish you all the best for a wonderful 2022!

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European Outlook: Beware of Basel 4

Jeremy Batstone-Carr, *European Strategy Team,* Raymond James

European stock markets have started 2022 very positively. At first glance, this looks to be good news and perhaps an early vindication of the fact that regional bourses trade at an attractive valuation discount to their US counterparts.

On a "through the cycle" price/earnings ratio and taking account of anticipated future corporate earnings, European equities trade on a multiple of 15x against an equivalent of 23x, but it hardly tells the whole story. Yes, European equity benchmarks are characterised by significantly greater cyclicality than the U.S. and should, perhaps, perform well were regional economic activity to strengthen. The latter's equity benchmarks were driven by a small handful of mega-cap tech names over 2021 whilst some 60% of index constituents currently linger below their 200-day moving average. Perhaps 2022 will be the year in which this valuation divergence diminishes?

> "The European Commission's outlook for this year, published in mid-November, certainly paints a rosy picture."

The European Commission's outlook for this year, published in mid-November, certainly paints a rosy picture. Then again, there are good reasons why the single currency bloc should trade at a discount to the U.S.

The Commission's projections admit that the Eurozone faces mounting headwinds; the Coronavirus pandemic is still with us and case numbers are spiking (albeit that hospitalisations and fatalities remain subdued relative to those of the recent past), while inflationary pressures are persistent and becoming less transitory and more entrenched with every day that passes. The official response to the former has been profoundly varied (Sweden versus Austria for example) and in relation to the latter, non-existent. The European Central Bank (ECB) first announced a tapering of its Pandemic Emergency Purchase Programme (PEPP) on 9 September 2021. On the face of it, this seems sensible, but in reality, all it represents is an adjustment to a lower net supply of bonds from sovereign issuers. Whilst the PEPP programme is scheduled to conclude this year, the underlying Asset Purchase Programme will continue to acquire 100% of all net sovereign issuance going forward.

By so doing the ECB is, perhaps unwillingly, acknowledging that no real secondary market exists for the region's sovereign debt at yields driven down by years of quantitative easing. Most investors would likely prefer to accept twice, or even three times, prevailing yields given the region's deep-seated and persistent structural uncertainties.

Indeed, the ECB has effectively admitted that, by its actions, monetary policy has morphed from being a tool to support the implementation of much needed structural reforms, to a tool

> “ The ECB’s own estimates confirm that following massive deficit spending in 2020, governmental fiscal largess will have risen again, by 3.4% when data for 2021 is released, and to fall only slightly, by 1.2% in 2022 ”

that actively avoids them! Even allowing for the robust economic rebound both the Commission and the central bank forecast for this year, few regional governments are willing to reduce spending and curb elevated deficits in any meaningful way. The ECB’s own estimates confirm that following massive deficit spending in 2020, governmental fiscal largess will have risen again, by 3.4% when data for 2021 is released, and to fall only slightly, by 1.2% in 2022.

> “...regional government spending will consolidate the COVID pandemic increase, with very little in the way of improvement in the fiscal position of most countries.”

What this means is that regional government spending will consolidate the COVID pandemic increase, with very little in the way of improvement in the fiscal position of most countries. In fact, countries such as Italy and Spain have actually seen their structural deficits increase.

What is entirely apparent is that persistent negative rates and equally persistent liquidity injections, combined with relentless government spending, have delivered no obvious multiplier effect. It is worth reminding ourselves that the region’s major economies were stagnating even before the onset of the pandemic and despite the Juncker Plan which drove hundreds of billions of euros in investment. Worse still, despite ECB Governing Council member, Mr Klaas Knot’s recent observation that the central bank is “on track to end bond purchases completely by end-2022, following which the policy rate can go up”, the majority of senior policymakers acknowledge that the central bank is effectively trapped by its own policy. Any attempts to normalise over and above that already announced would likely have a significant adverse impact on the region’s bond markets and in consequence, deeply indebted governments would suffer the impact of a sharp increase in borrowing costs. Yet on the other side of the coin, it cannot maintain the current pace of monetary support because inflation is imparting significantly adverse pressure on the growth outlook.

> “The broader challenge for both regional governments and the central bank is that the prevailing policy setting...”

The broader challenge for both regional governments and the central bank is that the prevailing policy setting, whilst appropriate to address the worst of the impact from the pandemic, completely ignores demographic and other structural impediments to long-term sustainable growth. The region has an ageing population, a fact which the prevailing monetary and fiscal policy setting overlooks, ignoring the evidence of altered consumption patterns when citizens reach retirement age. To add to this the demographic challenge, the fact that the region’s taxation system routinely hampers the middle classes, businesses and investment, the inescapable conclusion is that the policy-setting looks eerily similar to that implemented by Japan in the early 1990s.

And so, inevitably and inexorably, to TARGET 2. Under the guise of “whatever it takes”, Dr Mario Draghi, the former president of the ECB, swept all regional bad debts under the convenient cover of the regional banking settlement system.

> “By this subterfuge have still aggressively leveraged regional banks been prevented from failing...”

By this subterfuge have still aggressively leveraged regional banks been prevented from failing. Officially at least, no problem exists. This is because the ECB and all national central bank TARGET 2 positions net out to zero. To its designers, a systemic failure of TARGET 2 is inconceivable, but beneath the surface, some national central banks have mounting liabilities. The regional central bank bearing the greatest burden is the German Bundesbank, now lending well in excess of a trillion euros through TARGET 2 to those other regional central banks seen to be exploiting the system. The mounting risk of rapidly accelerating losses, due in large part to COVID-related lockdowns, is a clear and present danger.

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The new Bundesbank President, Herr Joachim Nagel, may have been brought in to address soaring inflationary pressures, but in reality, he has a much bigger headache to deal with. What might precipitate a crisis is the likely phased introduction of the delayed suite of Basel 4 regulations from January 2023. Banking sector compliance, to ensure resilience, will likely involve reducing risk-weighted assets. With more than half an eye on these impending rule changes, the regional banking sector seems unlikely to provide the general expansion of credit required to support the Commission (and ECB's) optimistic growth forecasts.

This analysis conclusion is that the Eurozone is facing a crisis that may, ultimately, call into question its very existence. Importantly, the crisis outlined above, differs significantly from that potentially facing the United States. The latter's issues derive, essentially, from the consequences of excessive money printing. Whilst similar policies have been pursued in the Eurozone, problems are more structurally deep-seated.

"The cumulative effect of an over-leveraged banking system and a settlement system devoted to the concealment of bad debts is that the region's economies have become progressively less efficient."

The cumulative effect of an over-leveraged banking system and a settlement system devoted to the concealment of bad debts is that the region's economies have become progressively less efficient. The advent of Basel 4, unless it is postponed again, could prove the trigger for a take-down of the region's banks, its central banking network and even the euro itself, ultimately the glue that holds the entire project together.

Whilst 2022 will surely throw up some specific opportunities, both at the sector and individual stock level, in the round the region's persistent equity market discount to the United States appears entirely warranted and its bond markets supported by a programme which may have but a limited shelf-life.

KEY TAKEAWAYS:

- European equities trade at a lower valuation multiple than do the US, but a discount seems warranted.
- By its actions, the European Central Bank's (ECB) monetary policy settings have evolved to an extent that reduces the pressure for urgent structural reform.
- Persistent negative rates, liquidity injections and government spending have delivered little obvious multiplier effect on the real economy.
- The phased introduction of Basel 4 banking regulations from Jan 2023 will likely hamper the extension of the credit necessary to support the delivery of medium term growth forecasts.

2022 US Economic Outlook: Turbulence Ahead

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

The US economy experienced a number of surprises in 2021, some good, some bad. The outlook for the coming year is likely to be even more volatile with inflation and Federal Reserve (Fed) policy as the major factors. Higher inflation in the spring of 2021 was narrow and expected to be transitory, but by the end of the year there were growing fears of a more persistent, broader increase in inflation. With that, financial markets expect tighter monetary policy and a possible policy mistake. Time will tell, as they say, but investors should be prepared for the ground to shift repeatedly in 2022.

Abraham Lincoln wrote, "If we could first know where we are, and whither we are tending, we could then better judge what to do, and how to do it." We began 2021 with expectations of a fiscal policy contraction (less support than in 2020). Democrats could gain control of the Senate if they won two Senatorial run-off elections in Georgia, which seemed unlikely. Yet, it happened. Still, the passage of a massive fiscal stimulus package would be difficult. With narrow majorities in the House and Senate, moderate Democrats would likely baulk at adding so much to the federal debt. However, the incoming administration was determined not to repeat past mistakes (many economists believed the 2009 stimulus was not enough to offset the damage of the 2008 financial crisis). The $1.9 trillion American Rescue Plan Act of 2021 followed $3.2 trillion in stimulus passed in 2020 and helped propel strong growth in the first half of the year. Vaccines arrived earlier than anticipated, which helped the economy to reopen more rapidly.

> GDP growth should be slower, but still beyond a long-term sustainable pace. Our expectation is GDP growth will be approximately 3.5% in 2022.

GDP, SUPPLY CHAINS, & INFLATION

Real gross domestic product (GDP) rose at a 6.5% annual rate over the first two quarters, but that understates the economy's strength (as lower inventories and a wider trade deficit subtracted from the headline growth figure). For the key components of GDP, consumer spending rose at an 11.7% annual rate in the first half, while business fixed investment advanced 11.1%.

The arrival of the Delta variant, which was more transmissible than the original virus, combined with a large fraction of the pop-

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ulation’s reluctance to accept vaccines, dampened the pace of improvement in the third quarter. Growth was also restrained by supply constraints, especially in motor vehicle production. Recent data suggest a rebound in growth in the fourth quarter.

Supply chain difficulties occur in every economic recovery, but the ongoing pandemic meant that repairing production and transportation bottlenecks would take more time than usual. By late summer, port delays in Southeast Asia and Southern California contributed to a rough start to shipping for the holiday season. Supply issues were compounded by a surge in the demand for goods. During the pandemic, consumer spending shifted from services to goods. That shift was expected to unwind as the service side of the economy improved, but it didn’t. Spending on consumer goods has remained well above the pre-pandemic trend.

Strong demand and restrained supply is a recipe for higher inflation. Inflation picked up in the spring, partly reflecting ‘base effects’ – a normalisation in prices that had been depressed a year earlier – but there were restart pressures as well, especially evident in prices of raw materials and in new and used motor vehicles. In the spring, the increase in inflation was narrow, concentrated in just a few components of the Consumer Price Index, but by October, higher inflation was beginning to broaden across categories.

WAGES AND INFLATION

Inflation expectations play an important role in the Fed’s policy outlook. It’s not so much that inflation expectations predict actual inflation (they don’t), it’s that a mindset of higher inflation becomes engrained. Workers are likely to demand better wages and firms are more likely to try to raise prices. Near-term inflation expectations have risen, but longer-term inflation expectations have remained consistent with the Fed’s goal.

Wage inflation tends to follow price inflation, but (depending on how easily firms can raise prices) higher wage inflation can reinforce higher price inflation, creating a wage-price spiral. This is the story we tell about the Great Inflation of the 1970s and early 1980s. Union power was much stronger then and there is a greater concentration of large firms now. Wage bargaining power has shifted toward firms and away from workers over the last 40 years. Still, the labour market is tight. Firms are reporting greater difficulty in hiring and retaining workers, quit rates hit record levels in the early autumn, and labour costs continue to rise.

Job growth was strong in 2021, although non-farm payrolls are still below where they were before the recession. Labour force participation fell during the pandemic, reflecting dependent care issues and early retirements. There is even some recent evidence of un-retirements (returning to the labour force after retirement) for those in their late 50s and early 60s. However, fewer older Americans have gone into nursing homes during the pandemic and childcare is more expensive and less available. Labour force participation has been trending flat over the last year.

It’s likely that higher wages will encourage a return to the workforce and slow the exit of older workers. President Biden’s Build Back Better plan includes childcare support, but even if passed, it would take some time to implement. Beyond the short-term dynamics, the demographics of an aging population imply that labour force participation should trend lower over time.

FED POLICY

The Fed’s view was that inflation pressures would likely be transitory, meaning not permanent. However, the rise in inflation expectations, continued supply chain strains, wage pressures, and the broadening of price increases is a worrisome combination. The Fed recognises the risk of a more persistent increase in inflation.

The Fed began to reduce (‘taper’) its pace of asset purchases in November, lowering purchases of Treasury securities and mortgage-backed securities by $15 billion each month, but will accelerate that pace in January (taking purchases down to zero in March of 2022).

The Fed’s Large-Scale Asset Purchase program (LSAP, commonly called quantitative easing or QE) was an important tool during

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the pandemic, but the economic recovery no longer needs that much support. Fed officials were worried that tapering could cause some disruptions in the credit markets, so its approach to tapering would be gradual. Fed officials emphasised that the decision to taper was separate from the decision to raise short-term interest rates. However, the increased risk of more persistent inflation has altered the outlook.

In 2019, the Fed revised its monetary policy framework. No longer would the Fed act pre-emptively to head off higher inflation. Instead, it would wait for inflation to show up, tolerating a moderate increase in inflation, but would still maintain a 2% long-term goal (as measured by the PCE Price Index). The Fed also broadened its employment objective, making it more inclusive. Low-wage workers and communities of colour fare the worst during an economic downturn and are slower to recover in an expansion.

The Fed appears to face a tradeoff in 2022. If it waits too long to raise short-term interest rates and higher inflation becomes more rooted, it will eventually have to raise rates more to get inflation back down, slowing economic growth and risking a recession. Most likely, the Fed will begin to raise short-term interest rates by the middle of 2022 and proceed gradually, but a lot depends on the evolution of the economy.

So, what does all this imply for the 2022 economic outlook? Much of the growth in 2021 was a recovery from the pandemic. A key factor in the 2022 outlook is that there will be less to rebound from. With less ground to make up, GDP growth should be slower, but still beyond a long-term sustainable pace. GDP growth will be ~3.5% in 2022. Fiscal policy will be contractionary compared to 2021. Labour market constraints are also likely to remain an impediment to faster growth. Higher wages should pull many back into the workforce, providing some upside to the growth outlook, but it's hard to say for certain.

We're unlikely to see another round of government support for individuals. At the same time, consumer spending growth should remain supported by a strong trend in wage and salary income. Some of the 2021 government support was saved, showing up in higher balances in checking and savings accounts. That savings will be reduced over time, but should provide some near-term cushion for spending. While consumer spending did not shift back from goods to services in 2021, that ought to show up more in 2022 – but a lot depends on variants of the virus. A lockdown of the economy is unlikely, but fear of the virus may dissuade some individuals from returning to pre-pandemic spending patterns.

Strength in corporate profits supported business fixed investment in 2021. That support should continue in 2022, but at a more moderate pace.

Geopolitical tensions could be an issue in 2022, but the Fed will be the major factor, with the policy outlook expected to vary with the incoming data. Investors should watch developments closely and be prepared.

KEY TAKEAWAYS:

- The outlook for the coming year is likely to be more volatile than 2021 with inflation and Federal Reserve (Fed) policy as the major factors.
- Key components of GDP – consumer spending and business fixed investment – rose at an annual rate of 11.7% and 11.1%, respectively, in the first half.
- Near-term inflation expectations have risen, but longer-term inflation expectations have remained consistent with the Fed's goal.
- GDP growth should be slower, but still beyond a long-term sustainable pace. Our expectation is GDP growth will be approximately 3.5% in 2022.

Spotlight on Supply Chains

Tracey Manzi, CFA, *Investment Strategist*, Investment Strategy

Supply chain disruptions have wreaked havoc on the global economy since the pandemic began nearly two years ago. The logistical challenges of balancing factory shutdowns, health concerns, and an unprecedented demand surge have created bottlenecks across nearly every aspect of the global supply chain. While supply chain constraints remain severe, there are tentative signs that some of the logjams are beginning to ease.

SIGNS OF PEAK BOTTLENECK

For much of the last year, media headlines have been dominated by stories of port congestion, labour shortages, product delays, and elevated shipping costs. It should come as no surprise that supply chain disruptions have emerged as one of biggest buzzwords in 2021, not only in company earnings calls, but also among consumers. The White House has even appointed a task force to address transportation and logistics bottlenecks stemming from the pandemic. Not to make light of the seriousness of the situation, but when a market trend is splashed all over the news or makes its way onto the cover of a magazine, it usually indicates the trend has reached a turning point.

Supply chain logistics are notoriously complex, but one of the clearest measures of the disruptions caused by the pandemic can

> While supply chain constraints remain severe, there are tentative signs that some of the log-jams are beginning to ease.

be seen in the sharp acceleration in the Institute for Supply Management's (ISM) Supplier Deliveries Index. This timely measure, which captures the extent of supply chain delays in an economy, is running near its highest levels since the 1970s. While it is not unusual to see readings above 50 during economic recoveries, the lengthy delays have been exacerbated by exceptionally strong demand for goods during the pandemic, factory closures across key global manufacturing hubs such as China and Southeast Asia, and escalating shipping costs.

Although Asia was among the first to emerge from the pandemic, new waves of infections and low vaccination rates forced authorities to reimpose restrictions earlier in the year. This came at a time when vaccination rates ramped up sharply in other parts of the world and economies were kicking into high gear. With the global economy not in sync, the factory shutdowns across Asia aggravated an already overwhelmed supply chain. After months of growth-sapping lockdowns and significant improvements on the vaccine front, restrictions were relaxed, with many countries now moving away from their zero-tolerance COVID policies. As factories across Asia revved up, supply chain constraints have started to ease. This is an important, yet understated, part of the supply chain story given China and the ASEAN region's dominant position in global trade.

Freight shipping rates started to roll over around the same time that Asian factories started to reopen. While it is not unusual to see shipping rates fall as seasonal demand starts to wane, this has been a welcomed change from the blistering rise in freight rates since the pandemic began. One of the key indicators we've been following is the Baltic Dry Index, which tracks the cost of shipping commodities across 23 different shipping routes. Since early October, Baltic Dry Index prices have plummeted over 50%. The cost to ship goods from Shanghai to Los Angeles is also down over 20% from its peak in September. As the chart below shows, the lengthening in supplier deliveries has moved in tandem with higher transportation costs. With freight costs now tumbling and Asian factories reopened, supplier delivery times are likely to correct.

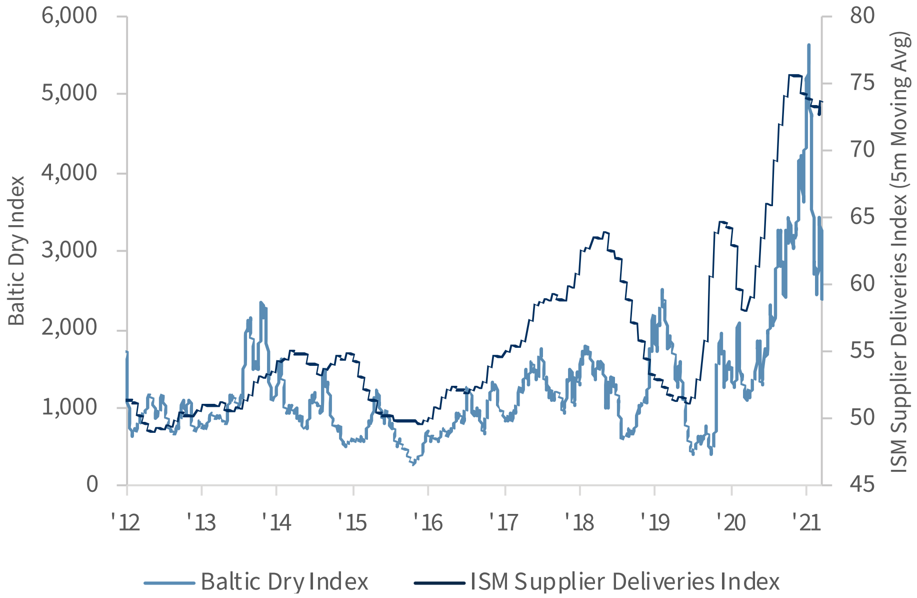
Port congestion remains an issue in the supply chain. While the major ports have a long way to go to reach pre-pandemic levels of efficiency, they are making considerable progress working through the current logistical issues. While the number of ships at anchor on the West Coast remains at elevated levels, other metrics suggest there is light at the end of the tunnel. For example, despite the challenges, the port of Los Angeles continues to process a record amount of cargo volume, the number of import containers sitting on the docks has fallen over 30% since late October and incoming traffic continues to fall. With seasonal volumes expected to slow further between now and early next year, the logjams at the ports should continue to ease.

The combination of soaring demand, saturated ports, and increased shipping costs have translated into a sharp acceleration in business costs and selling prices, which, for now, have been easily passed onto to consumers. This is not all that surprising, as suppliers tend to have greater pricing power when there are widespread supply constraints. However, with the bottlenecks easing and transportation costs starting to retreat, it is reasonable to assume that the pipeline pressures that have translated into higher consumer prices will begin to fade. This would be welcome news for policymakers, who have become increasingly concerned about inflation, which is near a four-decade high.

Another timely indicator that provides a glimpse into the supply-demand imbalance is the ISM's Backlog of Orders Index. This measure shows a company's ability to meet consumer demand. Much like some of the other indicators that we follow, order backlogs have moderated significantly over the last few months. Despite all the news reports about low inventories and companies being unable to meet consumer demand, the decline in the

Shipping Rates Have Declined Substantially

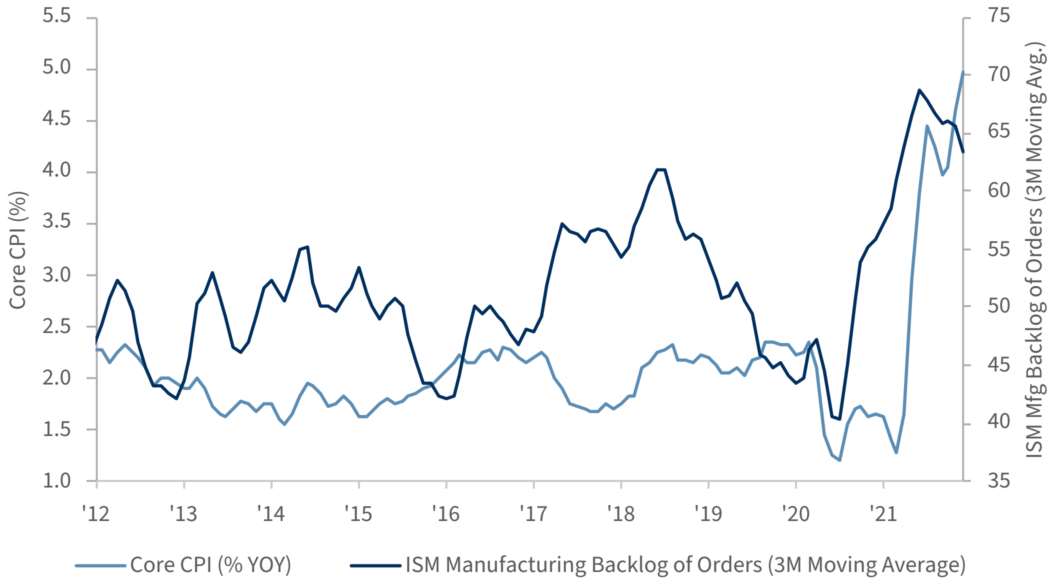
Rising transportation costs and longer delivery times reflect the severity of the recent supply chain disruptions. Sharp declines in shipping costs and improvements in supplier delivery times suggest that we may be at peak supply chain stress.



Source: FactSet, as of 12/17/2021

Supply Pressures Have Stoked Inflation

Supply chain pressures have had a direct impact on inflation. While still elevated, the recent downturn in the Backlog of Orders Index suggests suppliers are starting to catch up with demand. As suppliers continue to work through the imbalance, price pressures should start to fade.



Source: FactSet, as of 12/17/2021

backlog of orders suggests that companies are sourcing what they need to fulfil orders. With companies catching up on the orders as the supply chain normalises, this should put further downward pressure on pockets of inflation that have driven headline inflation numbers higher.

While it is difficult to forecast when the supply chain will fully normalise, the recent developments we've flagged are encouraging signs. With new capacity being added across the supply chain, cargo spending shifting from sea to air, and a ton of goods still waiting to come onshore, it is highly likely that the inflationary environment we're grappling with today is setting up to bring significant disinflationary pressures later in 2022 or early 2023.

WHAT IMPLICATIONS DOES THIS HAVE FOR INFLATION?

The stresses in the supply chain have not derailed growth, but they have added a lot to inflation over the last year. The longer this exists, the more concerned policymakers get about inflation expectations becoming unanchored. With inflation now running at uncomfortably high levels, it is prudent for policymakers to be concerned. Hence, Chairman Jerome Powell's recent hawkish pivot. While the Fed is expected to shift to a less accommodative policy stance in 2022, policymakers should not have to tap on the brakes too hard if supply chain bottlenecks continue to ease and inflation pressures recede. This would be good news for risk assets, as the macro underpinnings of above-average economic growth and a still solid earnings outlook are likely to remain supportive.

KEY TAKEAWAYS:

- While the major ports have a long way to go to reach pre-pandemic levels of efficiency, they are making considerable progress working through the current logistical issues.
- With companies catching up on orders as the supply chain normalises, this should put further downward pressure on the pockets of inflation that have driven headline inflation numbers higher.
- While the Fed is expected to shift to a less accommodative policy stance in 2022, policymakers should not have to tap on the brakes too hard if supply chain bottlenecks continue to ease and inflation pressures recede.

All Quiet on the Eastern Front

Jeremy Batstone-Carr, *European Strategy Team,* Raymond James

Late one night, around twenty-five years ago, a train pulled out of London's Waterloo Station. To the casual bystander, if any were around at that time, they would have seen empty coaches save for two people, sat opposite from each other but heads bowed conspiratorially together. One, the elder, was Jim Slater, financial tycoon and City grandee, the other, younger, was this writer. We both had been attending a City conference, Slater as the keynote speaker, I a mere delegate. Slater was in an ebullient mood, the conference had gone well and he was keen to expand. This writer had another subject for discussion.

It is high summer, 1972. Barely out of short trousers, the writer and his fellow school friends were transfixed by events unfolding in Reykjavik, Iceland, the location of the battle for the World Chess Championship. Pitted against each other were the brilliant, likeable and gentlemanly Boris Spassky and on the other side of the board and representing the United States, the maverick, misanthropic genius that was Bobby Fischer. The Cold War's nuclear threat had, for the time being, subsided and the United States had, not long before, put a man on the moon.

The Soviet Union was keen to explore other routes by which to attempt to assert its intellectual superiority and chess, much favoured, was just such an avenue. Getting the 24-match series on had proved complex from the outset. The then US President, Richard Nixon's National Security Adviser, Dr Henry Kissinger, had personally interceded to remind Fischer of his patriotic duty, but what finally brought the latter to Iceland was a doubling in the prize money, put up by Slater himself.

What followed had the world in its spell. It is said that 18 of every 21 bars in Manhattan switched TV channels from the New York Mets' baseball and the Democratic National Convention, to events unfolding in Iceland.

"In the UK, chess was the first item on the national news and, temporarily, the dartboard was swapped for the chessboard as matches..."

In the UK, chess was the first item on the national news and, temporarily, the dartboard was swapped for the chessboard as matches were followed and played out move by move. Game six is still said to this day to be a thing of beauty, as close to perfection as a Mozart symphony. At the end, a game won by Fischer, even his opponent stood up to applaud him. Game ten proved that Spassky was not there simply to make up the numbers. His victory had the audience chanting his name to the rafters.

> “The Soviet Union is long gone, but to this day the chess pieces are still being moved around the board.”

So, to what proved the pivotal game thirteen. At move 69 Fischer delivered an extraordinary gamble, an action worthy of three question marks and three exclamation marks in chess notation. How might Spassky respond? For hours the Soviet consulted with his seconds and paced the corridors of the convention centre alone. To riposte and fight fire with fire, or defend? Ultimately, he chose to wait and see. Fischer needed no second invitation. In for the jugular, the game was over soon after. Spassky's face visibly crumpled, his opponent's domination assured. The game had lasted nine-and-a-half hours! To this writer, a life-long interest in geopolitics had begun.

The Soviet Union is long gone, but to this day the chess pieces are still being moved around the board. Contemporary focus is, of course, on the Ukraine, a country of prime geopolitical “real estate” located at the intersection of two very different economic systems. The European Union derives around 25% of its natural gas imports from Russia, 80% of it via a pipeline running through the embattled country. Germany is almost wholly dependent on Russian gas and European industry, including c.40% of its energy-generating capacity is profoundly reliant. A bilateral dependence exists between Russia and the bloc to its west. Europe needs the natural gas to drive its economy (a necessity only temporarily alleviated by the arrival of an armada of container ships from North America), and Russia needs the revenues from gas sales to run its government and service its foreign currency debt.

Upping the geopolitical ante, Russian troops are said to have built up on the Ukraine's Eastern border, close to the economically significant Donbass coalfield. Might Russia invade? The West certainly suspects such a move and has threatened Moscow with draconian sanctions, especially to its banking system, were it to undertake such high stakes adventurism. Whilst considerable diplomatic efforts are underway to defuse the situation there is another player, of equal importance, with skin in this game; China.

> China today sends around 10% of its exports to the EU, by train along its much-vaunted belt-and-road initiative, the so-called modern “silk road”.

China today sends around 10% of its exports to the EU, by train along its much-vaunted belt-and-road initiative, the so-called modern “silk road”. Beginning in 2016, China has been investing heavily in Ukrainian infrastructure with the intention of building an alternative route to options passing through Russia and Belarus. Given the latter's political isolation by the EU and the closure of its border with Poland, the route crossing the Ukraine has become the only way to move goods easily to Western Europe from China without crossing into Russia.

> “...an extremely cordial video Summit between President's Putin and Xi in mid-December appears to confirm the onset of an idyllic phase in the relationship between the two countries.”

Once seen as a potential vulnerability, an extremely cordial video Summit between Presidents Putin and Xi in mid-December appears to confirm the onset of an idyllic phase in the relationship between the two countries.

The Chinese state is said to have invested the equivalent of around one billion dollars in building compatible railway infrastructure, as well as a ferry system crossing the Black Sea commensurate with the transportation of cargos to the port city of Odessa, or through the Bosphorus to Europe. Beyond this, Chinese companies have, in turn, invested a further billion dollars equivalent in plant and other facilities in the Ukraine closely resembling, in so doing, China's economic colonisation of many other countries around the world.

It seems certain that Russian tanks are not going to sweep into Kiev, the Ukrainian capital, and onward to the Black Sea coast without disrupting Chinese interests. For its part, having constructed what is surely an extraordinary piece of engineering architecture, China can deploy its own troops and equipment to the Ukraine at least as fast as any other interested global military power. Thus, it represents a critical step, if Russia were to make a move on the Ukraine to assume control of the latter's gas and coal fields, that it does so with the overt support of Beijing.

"Western powers have expressed concern regarding the overly friendly nature of Mr Putin and Mr Xi's mid-December video conference..."

Western powers have expressed concern regarding the overly friendly nature of Mr Putin and Mr Xi's mid-December video conference; it smacks of a plan possibly to divvy up the Ukraine to further both Russian interests and China's economic reach to mutual advantage. A Russian invasion, precipitating a shooting war with Ukrainians, might trigger a shooting war with the United States and Europe, over and above the imposition of far-reaching financial and economic sanctions. How would the Chinese respond? Any escalation involving that great superpower would surely turn the geopolitical screw to maximum and have significantly adverse consequences for global financial markets.

"...at the time of writing, an uneasy quiet has descended on Europe's Eastern front."

Financial markets have never been great at properly discounting geopolitical crises; a major event (whilst without doubt at the back of all investors' minds) lying at the outer reaches of the spectrum of discountable risks. It is very much to be hoped that military conflict can be avoided as 2022 begins and, as at the time of writing, an uneasy quiet has descended on Europe's Eastern front.

KEY TAKEAWAYS:

- A mutual dependency exists between Russia and the European Union. The EU is very dependent on Russian gas, while Russia is reliant on the revenue to run its government and finance foreign currency debts.
- China has a substantial economic interest in the Ukraine, the consequence of heavy investment in its "Belt and Road" initiative.
- Any escalation of the current situation would be significantly adverse for financial markets, but economic interests may trump military adventurism.

The Emerging Market World in 2022

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

This was a challenging year for the whole world, but judging by the full year equity market losses in Latin America, China, and (outside of India, the UAE and Saudi Arabia) many other emerging market indices, even recovering global economic growth numbers did not provide assistance. By contrast equity markets in the United States, the United Kingdom and Europe produced good gains. Little wonder that global emerging market indices – with nearly half the index focused on China – fell to a relative low against the sector diversified S&P 500 Index not seen since late 2002.

COMPARING MARKET PERFORMANCE

Underperformance can happen for many reasons, not all of which are immediately obvious. The largest four emerging market economies of China, Taiwan, South Korea, and India collectively account for just over three-quarters of global emerging market indices. Economic growth numbers in these names have collectively remained strong, with the economies in both China and Taiwan generating a positive GDP number for full year 2020, despite the COVID-19 challenges. And whilst populations are aging in all economies around the world, the scope for rising consumer expenditure and technological application have been notable drivers over recent years.

Of course any economic evolution take time. And that is especially true in China with its all-powerful Chinese Communist Party. Whilst the country's former leader Deng Xiaoping once noted that "to get rich is glorious," the last 18 months has seen the country's current leader Xi Jinping focused on the rise of the importance of 'common prosperity,' which has caused crackdowns on many important consumer, technology, and property sector companies in a manner materially different from forcing extra competition via breaking up dominant companies, as seen in a number of sectors in the developed world over the last century. No wonder stock markets in China and Hong Kong were negative performers across full year 2021.

> Growing emerging market economic power is an inevitable part of the 2020s.

However, growing emerging market economic power is an inevitable part of the 2020s. The initial rise – and further rise – of the consumer economy has been a dominant part of developed market growth over the past 30 years, as reflected by personal debt levels across countries in North America and Europe. From a trade perspective, there is a reason why the American president has spoken to the Chinese president three times over the last year. Whilst plenty of potential strategic challenges could be apparent during the 2020s, there is already too much in current trade flows to ever stop the leaders talking.

EMERGING MARKET OPPORTUNITIES

Emerging markets fundamentally have two opportunities and two choices. Beyond the rise of consumer spending, all emerging markets retain a material internal development opportunity.

Whilst every country in the world can see day-to-day life positively evolved by better education, healthcare, and business efficiency, the scope for positive change and impacts is most proportionately apparent in the emerging market nations. This has always been the case, as shown by the material improvements of the South Korean and Taiwanese economies over the last 50 years, countries which today should probably be

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

MSCI International Equity Indices – Country & Market Coverage

Developed Markets			Emerging Markets			Frontier Markets				
Americas	Europe	Pacific	Americas	Europe, Midddle East & Africa	Pacific	Americas	Central & Eastern Europe & CIS	Africa	Middle East	Asia
Canada	Austria	Australia	Brazil	Czech Republic	China	Argentina	Bulgaria	Botswana	Bahrain	Pakistan
United States	Belgium	Hong Kong	Chile	Egypt	India	Jamaica	Croatia	Ghana	Jordan	Sri Lanka
	Denmark	Japan	Colombia	Hungary	Indonesia	Trinidad & Tobago	Estonia	Kenya	Kuwait	Vietnam
	Finland	New Zealand	Mexico	Israel	Korea		Lithuania	Mauritius	Lebanon	
	France	Singapore	Peru	Morocco	Malaysia		Kazakhstan	Nigeria	Oman	
	Germany			Poland	Philippines		Romania	Tunisia	Qatar	
	Greece			Russia	Taiwan		Serbia		Saudi Arabia	
	Ireland			South Africa	Thailand		Slovenia		United Arab Emirates	
	Itlay			Turkey			Ukraine			
	Netherlands									
	Norway									
	Portugal									
	Spain									
	Sweden									
	Switzerland									
	United Kingdom									

Source: MSCI World Index

regarded as developed economy nations. Sadly, in some other countries elsewhere, a combination of politics, wars, crime, and corruption has been negatively impacted. Fortunately the rise of knowledge and awareness is improving.

As for the choices, it is much more than the 'Belt and Road' expenditure by the developing Chinese economy to a range of its emerging market peers across the world. The majority of large or mid-cap developed market companies will observe significant opportunities to grow their sales and profitability driven by rising populations and wealth levels in the emerging markets. The smartest choice for all emerging market countries is to encourage local entrepreneurs to find their own products and solutions. Slowly this is occurring more, reflected by the evolving research monitoring lists of global analysts and fund managers.

This is often seen by an acknowledgement that the emerging market world is always broader than many consider. This is not only because of the material economic progress of countries such as Taiwan and South Korea since the 1970s, but also the differentiation between formally defined 'emerging markets' and 'frontier markets' which are too small, risky, or illiquid to be generally classified as an emerging market economy, covering many countries in the Americas, Central/Eastern Europe, Africa, the Middle East and Asia such as Argentina, Bulgaria, Nigeria and Vietnam. There are reasons why frontier markets have the scope to outperform even their formal emerging market peers during the rest of the 2020s.

The second choice is focused on the environment, which was discussed by around 200 different countries in Glasgow, during last year's COP26 conference. Environmental matters – if ignored – may have a bigger impact on emerging market nations than any others. Many of the solutions however are global. Whilst many leading emerging markets feel that any environmental changes may take longer than in the developed world, it is also noteworthy to see the importance of the emerging market nations in the production of key clean energy metals such as copper, nickel, cobalt, and the rare earth metals. The anticipated COP27 conference in Egypt in November this year may well see growing awareness of the essential role of the emerging markets.

IMPACT ON DEVELOPED MARKETS

During 2021 only a handful of developed market central banks - including the Bank of England very modestly in December - raised their interest rates. By contrast nearly 35 emerging market central banks collectively over 110 times during last year, raised their interest rates, reflecting concerns about inflationary realities and the need to maintain positive real interest rates. And whilst both the American Federal Reserve as well as (again) the Bank of England look set to raise interest rates on more than one occasion during 2022, the People's Bank of China is far more likely to continue its recent interest rate reduction. Overall this is a range of noteworthy differences in a global equity market where the average developed market multiple is at a near two decade high against emerging market equivalents.

Geopolitical risks are always heightened in the world's emerging markets, but all countries have their opportunities and their challenges. Attempting to work out what is correctly factored in and what is not is always a key investment decision insight.

KEY TAKEAWAYS:

- Most emerging markets underperformed most developed markets during 2021, despite typically trading at a valuation discount.
- Emerging market investment offers a number of opportunities and challenges for the 2020s.
- The People's Bank of China looks set to cut its interest rates in 2022, in notable contrast to the average developed market central banks.

Energy Transition Is Here to Stay

Pavel Molchanov, *Director, Energy Analyst,* Equity Research

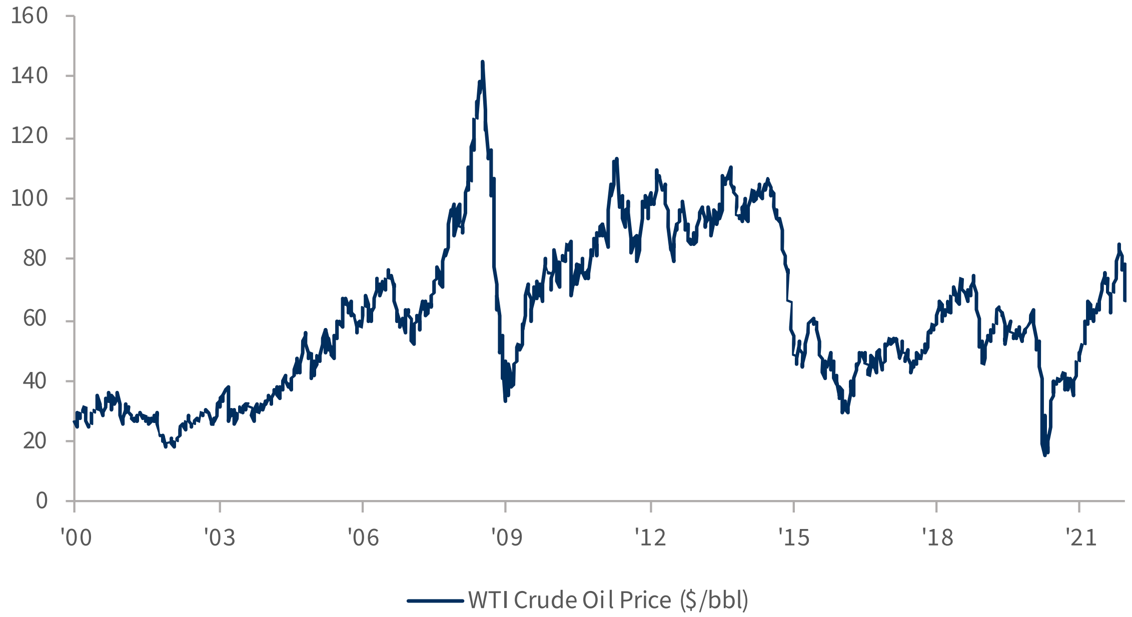
As many of our readers are painfully aware, Energy had been the worst-performing sector of the US equity market in the decade prior to 2021. However, as is often the case, what had seemed utterly hopeless turned out to be the trough. From the COVID-impacted debacle of 2020, when fundamentals (remember negative oil prices?) as well as investor sentiment hit rock-bottom, Energy ended up being the best-performing sector of 2021, up 60%. This reflects the post-crisis rebound in the oil market, with spot oil prices rallying 50%, and US natural gas up a similar amount. That said, the oil and gas industry's cash flow approximately tripled in 2021, so in that sense, the stocks didn't do quite as well as some might have expected. The lesson here is that the market is always forward looking: with the commodity futures curve pointing to price declines in the years ahead, the stocks are pricing in less stellar, though still solid, profitability in the future. In an even broader sense, Energy remains less than 3% of S&P 500 market cap – down from as much as 13% a decade ago – illustrating that this remains quite a contrarian sector for investors.

> Energy transition is an irreversible megatrend – and, ultimately, more important for the Energy sector than either COVID or geopolitics.

OIL & NATURAL GAS OUTLOOK

So, what does 2022 have in store for the oil market? Let's first acknowledge that predicting oil prices involves, to borrow a phrase, both 'known unknowns' and 'unknown unknowns.' Demand has essentially recovered to pre-COVID levels – hence the past year's bounce in the oil market to the highest levels since 2014 – and we anticipate that demand should continue to firm up. However, even with the global vaccination rate (one or more doses) approaching 60%, there is no escaping the fact that pandemic-related headwinds, especially in aviation, are still a headwind for demand. On the supply side of the equation, OPEC and Russia are gradually restoring production to pre-COVID levels: the only question is, how quickly this process will unfold. Meanwhile, the ongoing nuclear negotiations between Iran and major powers are a source of uncertainty vis-à-vis supply, and the same holds true of weather events such as hurricanes and wildfires.

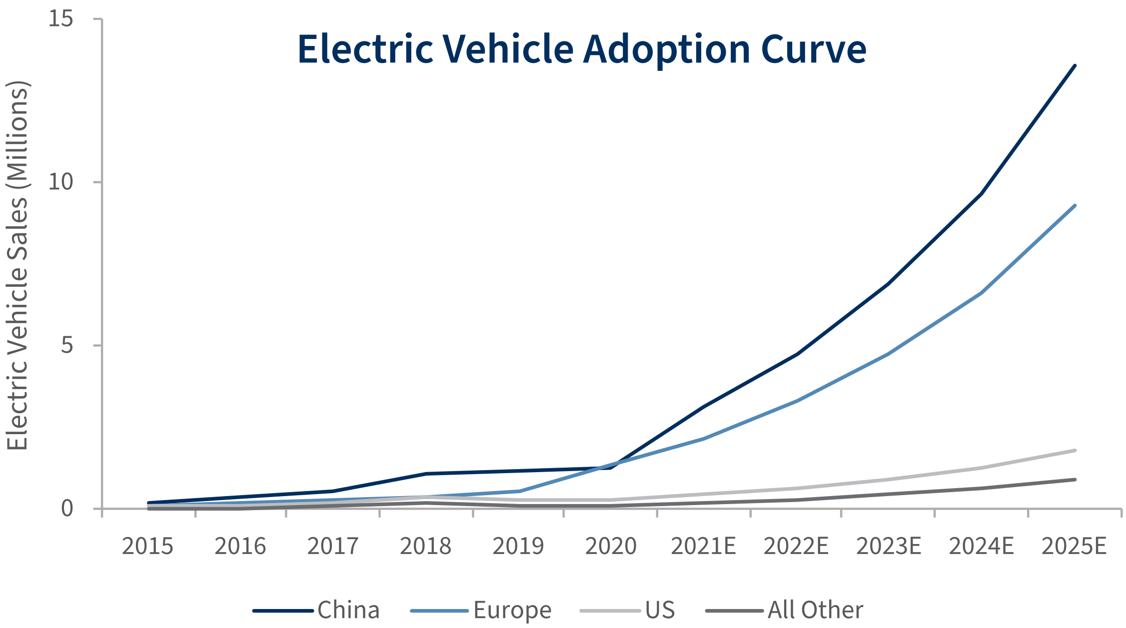
Spot WTI Oil Price



Source: Factset, as of 12/17/2021

Finally, at a time of heightened inflationary concerns, macroeconomic question marks are also part of the backdrop. All that being said, we forecast that West Texas Intermediate (WTI) crude will average $75/Bbl in 2022, ending the year at $80/Bbl. Brent crude, the global benchmark, should remain a few dollars above WTI.

Natural gas is fundamentally regional in nature: prices on different continents can follow different patterns. In 2021, in fact, Europe was the standout for escalation in gas prices, amid the complex geopolitics surrounding gas supply from Russia. In response to unhappiness in Germany about the politically controversial Nord Stream 2 pipeline, Russia retaliated by curtailing exports. However, the US market was also very strong, for purely economic reasons: lack of investment in new supply at a time of strong demand from the post-crisis industrial recovery. In 2022, we envision the domestic Henry Hub benchmark averaging $4.50/Mcf.



Source: Raymond James Equity Research

Gas is always more seasonal than oil, so weather-related uncertainty is inherently greater. Interestingly enough, the higher oil prices go, the more downward pressure it will put on gas prices. The reason is this: all else being equal, higher oil prices incentivise more oil drilling and therefore more supply of what's known as associated gas, though it is true that oil and gas companies have become more disciplined with capital allocation, so the associated gas factor isn't as impactful as it has been historically.

ENERGY TRANSITION

While share prices of oil and gas companies continue to fluctuate with commodities, the past year also brought numerous reminders that energy transition is an irreversible megatrend – and, ultimately, more important for the Energy sector than either COVID or geopolitics. Energy transition refers to the gradual but inexorable trend away from fossil fuels, toward renewable and other low-carbon energy sources. This is happening for a combination of political/regulatory and economic/technological reasons. High commodity prices are an example of the latter category. When drivers are frustrated by expensive gasoline at the pump, they are more likely to buy an electric vehicle. Likewise, electric utilities unhappy about paying for expensive coal or natural gas are more likely to invest in wind and solar power plants. If, hypothetically, oil prices were to reach $100/Bbl – which, to be clear, we are not predicting – it would cause serious economic pain, but also have the side effect of accelerating the EV adoption curve. Recent headlines from China (coal shortages) and the UK (scarcity of drivers for delivering fuel) pointed to the importance of diversifying energy supply, even setting aside environmental considerations.

Near the end of 2021, the United Nations climate conference, COP26, drew attention to how governments around the world are approaching the issue of climate change. Broadly speaking, climate policy can be divided into 'sticks' and 'carrots.' Sticks include carbon trading programs – the largest ones are in the European Union and China – along with carbon taxes in countries such as Japan, South Africa, and Canada. These policies are designed to make carbon pollution more economically costly. Carrots include a wide range of incentives for clean energy technologies: everything from electric buses and green hydrogen (for businesses) to rooftop solar systems and energy-efficient appliances (for consumers).

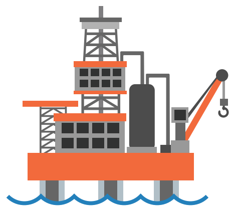
2022

Outlook on Prices: Looking Ahead

We expect to see oil prices increase throughout 2022 with lower prices earlier in the year and higher prices toward the end, averaging $75/Bbl for WTI and $78/Bbl for Brent.

WTI CRUDE

$80/Bbl



BRENT CRUDE

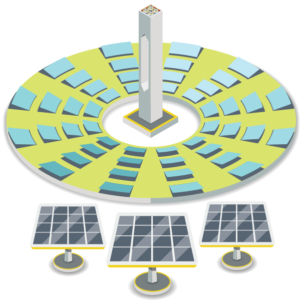
$83/Bbl

NATURAL GAS

$4.50/Mcf

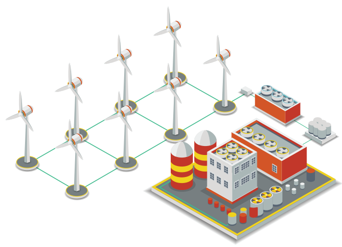
Source: Raymond James Equity Research

Low-Carbon Energy Technologies



SOLAR

- 4% of US electricity mix, but 40% of new power plants
- Highest market share in Hawaii, Puerto Rico, and California
- Internationally, key markets include China, India, Japan, and Germany



WIND

- 9% of US electricity mix, but 30% of new power plants
- Highest market share in the Midwest
- Internationally, key markets include China and the North Sea region

ELECTRIC VEHICLES

- 5% of US auto sales, up from 1% in 2015
- China and Europe together comprise more than 80% of global sales
- Several major automakers have pledged all models to be electric by 2035/2040

Needless to say, sticks are more politically sensitive, which explains why climate action at the federal level in the US – at a time when the Senate is divided 50/50 – will remain limited to carrots for the foreseeable future. There are, however, more ambitious policies in politically progressive ‘blue’ states. Furthermore, there is an important role for voluntary, self-motivated action on the part of the private sector. Governments can legislate net zero CO_2 emissions (carbon neutrality), but in the absence of such policies, plenty of multinational companies have set analogous targets for themselves. At a time when one-third of all professionally managed assets in the US – equity and debt combined – are in ESG funds, shareholders are influencing companies to take action even if policymakers are slow to jump on this bandwagon.

KEY TAKEAWAYS:

- Pandemic-related headwinds, especially in aviation, are still a headwind for demand.
- We forecast that West Texas Intermediate (WTI) crude will average $75/Bbl in 2022, ending the year at $80/Bbl. Brent crude, the global benchmark, should remain a few dollars above WTI.
- Energy transition is an irreversible megatrend – and, ultimately, more important for the Energy sector than either COVID or geopolitics.

DISCLOSURE

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