

INVESTMENT STRATEGY QUARTERLY

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39598



THE NEXT LEVEL UP

ARE YOU READY?

YES ◀

NO

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Letter from the Chief Investment Officer

The Next Level Up

Investors, it's time to power up! With technology changing the way we live, we are taking a trip down memory lane to look back at a piece of technology that has entertained generations: classic video games. Why? Because whether you are in a fictional gaming world or the real-life investment world, you need to be well prepared and ready for any challenges that come your way. We see these two worlds collide as we get set for the next level of play in the financial markets. Let's hit the start button and go!

The US economy has eluded obstacles and defied recessionary predictions like players in Frogger dodging cars and alligators to arrive safely home. Our economist believes that while the US economy will slow meaningfully from its recent leaping pace, recessionary concerns are fading. Yes, consumer spending is likely to be challenged by rising credit card balances, falling savings rates, and less robust employment growth, but record household net worth, boosted by house prices and a strong stock market will keep spending from collapsing. In addition, healthy government-induced corporate investments through the CHIPS and Science Act, Inflation Reduction Act, and Bipartisan Infrastructure Law are likely to offset any consumer weakness. As a result, rather than the mildest recession of all time, we slightly tilt our forecast to the softest of soft landings, pushing our US GDP forecast from 1.7% to 2.1% for 2024.

Of course, that also depends on how the Federal Reserve (Fed) plays its high-stakes Minecraft game of monetary policy. Fed Chairman Jerome Powell has the blocks to build a solid foundation under the economy, nourishing it with rate cuts if he chooses to use them. We expect three this year. But he must be on guard against the inflation monster as it might keep the Fed from paring rates as soon or as much as we expect. Current rates are already starting to hobble the US economy, particularly small business lending. But with short-term cash investments still yielding north of 5% and rates expected to come down slowly, investors do not have to rush to deploy outsized levels of cash to other asset classes. Patience is important as time will likely present better opportunities as we progress through the year.

Two people focused on the economy are President Biden and former President Trump—as the robustness of the economy has historically been influential in determining election outcomes. As we approach the 2024 election, both are already tossing barrels at each other like Donkey Kong to differentiate their platforms in an effort to secure a second term in the White House. Regardless of the winner, our most likely scenario is a split government, which will make any significant policy changes in Washington next year

very difficult.

Ms. Pac-Man characterises our fixed income strategy: consistently gobbling up coupon payments like the game's small pac-dots! That's one of the benefits of last year's dramatic rise in rates—bonds provide more attractive income potential. And, if US interest rates fall as we expect, you'll experience some long-awaited power-pellet performance via price appreciation. Rates may be volatile in the near term, due to the ghosts of monetary policy, inflation, and growth scares. But the biggest antagonist could be weak auctions of US government debt. While the appetite for these bonds remains healthy for now, any weakness in demand could lead to a spike in interest rates. But be sure to use any uptick in interest rates as the bonus fruits to temporary opportunities. The reason: our year-end target for the 10-year Treasury yield is ~3.75%. With solid corporate fundamentals and recession prospects dwindling, we favour high quality investment grade bonds. Corporate credit spreads may have narrowed to historically tight levels, but yields remain attractive.

Major international equity indices have notched new high scores in recent months. Large-cap tech stocks got a boost from the AI tailwind, like Super Mario powering up after eating a mushroom. However, market levels get more difficult and challenging as the investor moves on. Overly optimistic sentiment raises the bar both for earnings and economic performance. Disappointment could lead to pullbacks. But near-term volatility will not dampen the equity markets' long-term prospects. Remember, Mario must often backtrack before finding a way forward. Stay in the game: this isn't the final stage of this bull market.

The positive news is that our more favourable economic outlook allows us to upgrade our 2024 US earnings forecast to \$240 (from \$225), which increases our year-end target for the S&P 500 to 5,200. Small-cap equities remain attractively priced, both in the US and elsewhere and should benefit as international interest rates come down and growth remains resilient in the US and recovers elsewhere. From a sector perspective, our favourite US players are Technology, Health Care, and Industrials while equity market

leadership should broaden in other geographic locations. The evolution in tech is analogous to the progress we have seen in the sophistication of video games. From the limited up-and-down movement of a joystick, to increased buttons and commands on the controller, to motion-sensing remotes to full-on virtual reality immersion in another world—innovation continues to unfold at an astounding pace as the power of tech explodes.

The US dominates the video game industry with its vast number of developers. Similarly, we expect the US equity market, with the best forecast economic growth (and strongest upward revisions) in the developed world, to dominate. Contrast that with economic weakness throughout the European Union. Even European Central Bank rate cutting will likely have a limited near-term impact on those economies with where structural concerns prevail. However, one developed market country that may be able to continue to score is Japan. Despite soaring to record highs, Japanese equities remain attractive. They benefit from the weakness in the yen, investment fund flows out of China, and shareholder-friendly actions like buybacks. Shifting to the emerging markets, our long-term positive outlook is unchanged. Asia, particularly India, is experiencing some of the best growth estimates in the world, which should drive earnings. The shift in manufacturing to India away from China should spur its growth. That same trend of ‘friendshoring’ will likely continue to help Latin America, particularly Mexico.

It's been more than half a century since the debut of Pong, one of the first video games. These days, investors have been watching the oil market bounce between supply and demand. Supply has remained relatively stable as OPEC+ nations stick to their production cuts while the US and non-OPEC nations fill the gap

with ramped-up drilling. Demand is likely to rise as a global easing cycle gets underway and weakness in the worldwide economy recedes. As a result, we reiterate our year-end oil target of \$85 a barrel.

When it comes to asset allocation, a few vintage games come to mind. The first is the Midway Arcade car racing games, which allow players to choose the course (tricky and winding or straight and simple) and customise their cars, just as investors map their investment paths and select the risk/return profile they want to ride in the markets. The second is Tetris, which teaches evergreen lessons about fitting pieces together just right. Ensuring the right fit of all the pieces of your asset allocation is essential to maximising the risk-adjusted performance of your portfolio. Finally, the EAFC football series, formerly named FIFA, allows you to build ideal teams according to the skills of individual players—just like selecting the best investment vehicles for each asset class in your portfolio. In the end, with the proper asset allocation and guidance from your adviser, we hope you experience the ‘extended play’ of your financial resources to achieve all your goals and objectives and place your initials at the top of the leaderboard.

Challenge Accepted!



Lawrence V. Adam, III, CFA, CIMA®, CFP®
Chief Investment Officer

Investment Strategy Committee Members

Lawrence V. Adam, III, CFA, CIMA®, CFP® —Committee President, Chief Investment Officer

Eugenio J. Alemán, PhD Chief Economist, Raymond James

Professor Jeremy Batstone-Carr European Strategist, Raymond James Investment Services Ltd.*

James C. Camp, CFA Managing Director, Strategic Income, Eagle Asset Management*

Doug Drabik Managing Director, Fixed Income Research

Giampiero Fuentes, CFP® Economist, Raymond James

J. Michael Gibbs Managing Director, Equity Portfolio & Technical Strategy, Gibbs Capital Management*

Nick Goetze Managing Director, Fixed Income Solutions

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

Talley Léger Senior Equity Strategist, Investment Strategy

Joey Madere CFA Senior Portfolio Analyst, Gibbs Capital Management*

Tracey Manzi, CFA Senior Investment Strategist, Investment Strategy

Tavis McCourt, CFA Institutional Equity Strategist, Equity Research

Ed Mills Managing Director, Washington Policy Analyst, Equity Research

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Matt Orton, CFA Chief Market Strategist, Raymond James Investment Management*

Ellis Phifer, CFA, CMT Managing Director, Fixed Income Capital Markets

Chief Investment Office

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Matthew Ziyadeh, CFA, CIPM™ Investment Strategy Analyst, Investment Strategy

Lindsay Smith Investment Strategy Analyst, Investment Strategy

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Post-Pandemic US Economy: Different Strokes

Eugenio J. Alemán, PhD, *Chief Economist*, Raymond James
Giampiero Fuentes, *Economist*, Raymond James

We are normally reluctant to use trendy phrases to explain either our good and/or bad calls regarding the US economy. However, saying that ‘this time is different’ is more than fitting today to understand what has happened to the US economy since the recovery from the COVID-19 pandemic. US economic growth surprised friends and foes alike during 2023 as both the post-pandemic normalisation process continued and the Federal Reserve’s (Fed) attempt to bring down the surge in inflation contributed to the asynchronous performance of the US economy. During a typical economic cycle, as the economy hits the peak of the cycle, the Fed increases interest rates to slow down economic activity to avoid inflation becoming a problem down the road. That is, at the peak of the cycle, resources are fully utilised and thus any further pressure on the utilisation of these resources typically puts upward pressure on the price of these resources. However, this is not what happened at the end of the pandemic. The truth is that prices started to increase for several reasons, but none related to the actual workings of a typical economic cycle.

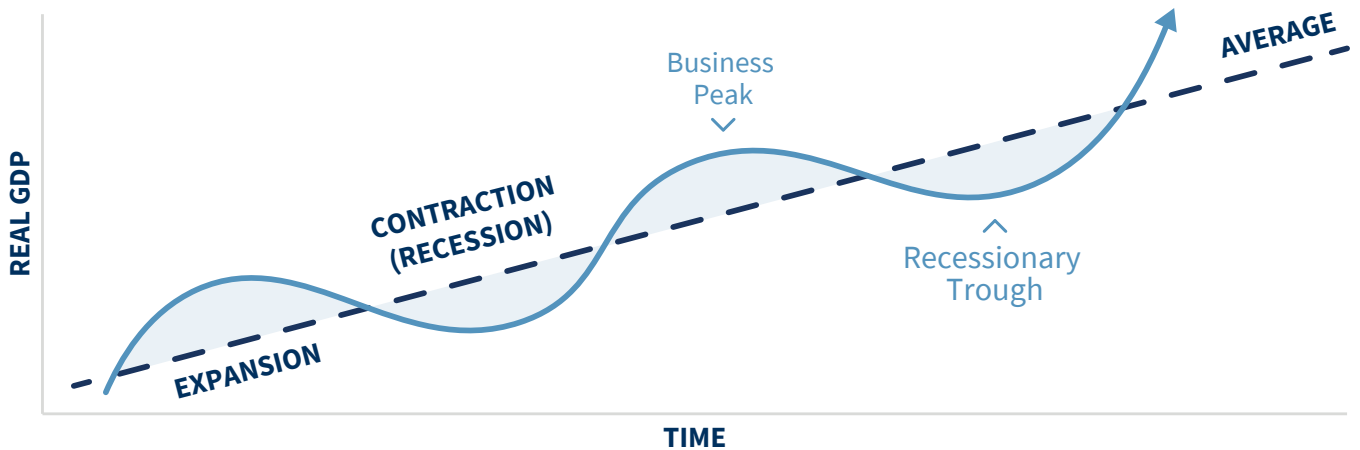
“This time is different.”

NAVIGATING THE PERFECT STORM

First, the total collapse of global production during the pandemic reduced the supply of goods while at the same time supply chain issues made the remaining goods very scarce and the acquisition of them extremely expensive. This meant that the increase in the price of the goods was not due to high economic growth but more to the inability to acquire goods cheaply and in a timely fashion. Second, the decline in the labour force participation rate due to the fear of contagion plus all the extra help given by the federal government meant that firms needed to entice workers to return to the labour force through increases in salaries/wages, especially in the service sector of the economy. This also contributed to a further increase in the cost of production and thus in the price of goods and services. Third, the immense amount of federal income transfers during the Trump and early Biden administrations helped Americans accumulate enormous amounts of money at a time when it was almost impossible to spend because the economy was shut down. This money was accumulated during the pandemic and contributed to putting even more pressure on prices as demand for goods skyrocketed during the pandemic while demand for services surged once the US economy reopened after the COVID-19 pandemic ended.

The Economic Cycle

Economies fluctuate over time through a process called the business cycle. The cycle has several stages: expansion, slowdown, contraction, and recovery. These cycles usually span several years.



ENTER THE FEDERAL RESERVE

Since price stability is one of the two mandates the Fed has, the other being low unemployment, and one of the only instruments the Fed has to bring down prices is by conducting monetary policy to slow down economic activity, the Fed embarked on one of the most aggressive interest rate campaigns in history to rein in prices.

However, the truth is that traditional monetary policy did not work, and it is still not working. The reason for this is that this wasn't a normal cycle where a reversal in monetary expansion, i.e., higher interest rates, would help keep economic growth contained or slow down economic growth to keep inflationary pressures at bay. This cycle was created by the COVID-19 pandemic recession as well as by a massive fiscal expansion. Once the production, supply chain, and labour scarcity generated by the COVID-19 pandemic recession were over, the federal government should have taken back, if not completely at least partially, the fiscal expansion created during the COVID-19 pandemic recession.

Of course, this would have been political suicide, so it was not even discussed, let alone implemented.

But monetary policy has not been benign during this tightening campaign. The housing markets felt the pain and real residential investment remained in recession territory for nine consecutive quarters. Furthermore, last year's banking crisis was also triggered by the inability of some banks to adapt quickly to much higher interest rates by adjusting their investments appropriately. Thus, regulators had to intervene and provide liquidity to stop runs on vulnerable institutions.

The increase in the price of the goods was due to the inability to acquire goods cheaply and in a timely fashion, the decline in labour force participation, and fiscal stimulus.

WATERFALL OF FISCAL SPENDING

As if this was not enough, after the end of the COVID pandemic, the federal government engineered an industrial policy that would keep non-residential investment surprisingly afloat even under otherwise very high interest rates. Both the passing of the Creative Helpful Incentives to Produce Semiconductors (CHIPS) Act, as well as the Inflation Reduction Act (IRA) and, to a lesser extent, the Infrastructure Investment and Jobs ACT (IIJA), helped reduce the impact of much higher interest rates on non-residential investment and have contributed to keeping the US economy afloat.

The IIJA is considered a generational investment to rebuild America's infrastructure, authorising \$1.2 trillion for transportation and infrastructure spending over five years. The bill included \$550 billion in new federal spending, with \$110 billion for roads and bridges, \$47 billion for energy policy, \$65 billion for high-speed internet access, \$56 billion for airports, and much more. The IIJA was a key component of President Biden's agenda, but after witnessing the supply chain disruption and shutdowns during the COVID-19 pandemic, as well as the increase of global geopolitical

risk, additional efforts were deemed crucial to both US national defence and other critical sectors of the economy.

While semiconductors were invented in the US, 90% of the world’s supply and 100% of the most advanced chips are currently manufactured overseas. Therefore, two industrial policy statutes were passed in 2022: First, the IRA provides incentives and uncapped tax credits for sustainability projects, clean technology, EV and battery production, and renewable energy such as solar and wind. Second, the CHIPS Act provides \$39 billion in direct spending on chip production and 25% uncapped advanced manufacturing tax credits.

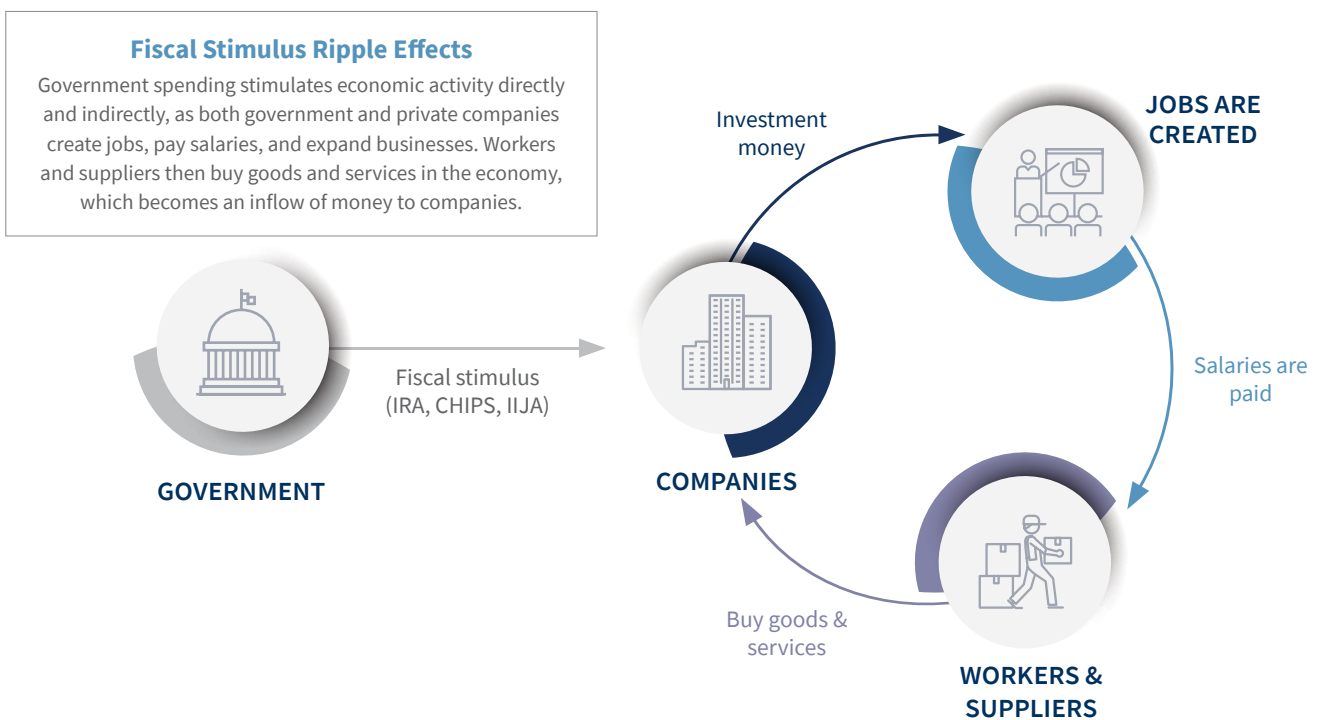
The benefits of these large investments trickle down to other sectors of the economy through a process called the government expenditures multiplier. The multiplier measures how much each one dollar increase in spending boosts the country’s economic output, essentially measuring the effectiveness of the government’s effort. While it is very complicated to accurately measure this number due to the multitude of factors impacting the economy at any given time, preliminary data suggests that the three packages have had and will continue to have an outsized impact on the US economy over the next several years. While the US government hasn’t released many funds yet, private companies have already either announced or started making very large investments in building new factories in the US with hopes of benefiting from the various government incentives. Since the pandemic started the

combination of these three packages has pushed US manufacturing construction spending higher by 175% to \$213 billion per year. Moreover, construction put in place for the manufacturing of computers and electronics has increased by more than 1,000% over the last two years.

CONCLUSION

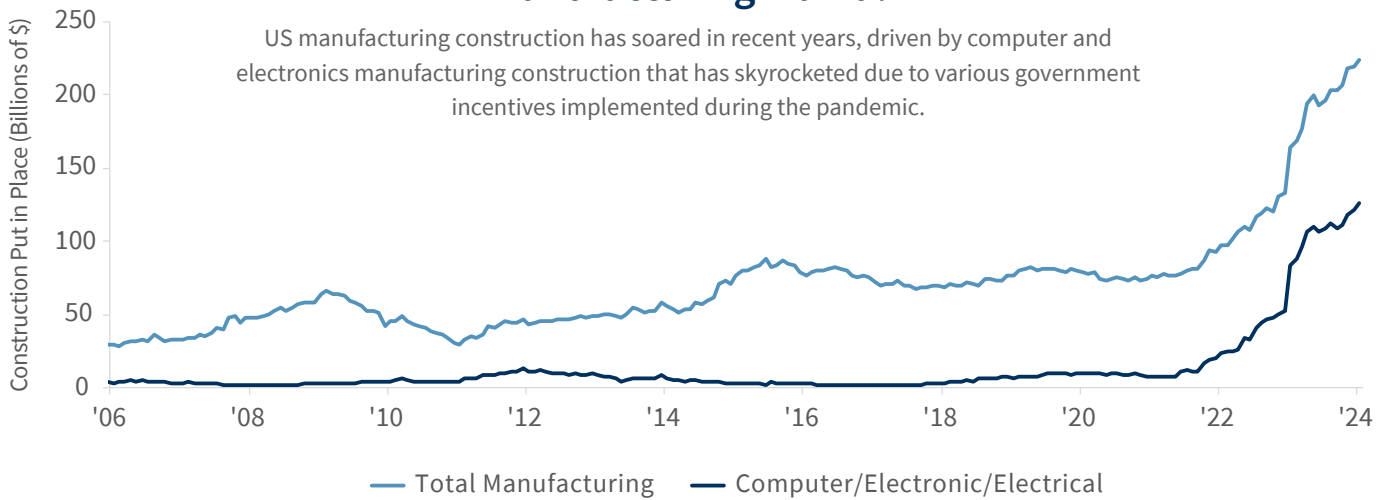
The fiscal policies implemented during the pandemic recession helped individuals and firms survive some of the most perilous times in more than a century and helped keep the economy going during the recession. However, many individuals could not spend the funds due to lockdowns and supply chain disruptions, pushing the personal savings rate higher than 30% during the early stages of the pandemic. However, as the limits imposed during the pandemic were lifted and supply chains normalised, the US consumer roared back with lots of excess savings ready to be deployed.

After inflation reared its ugly head during the recovery from the pandemic recession, the Fed could not stand idle and, while late, started raising interest rates. However, few sectors reacted to the increase in rates—mostly residential investment and the housing market—while other sectors were rescued by the three federal government acts that helped keep non-residential investment from reacting to higher interest rates.



Manufacturing Mania!

US manufacturing construction has soared in recent years, driven by computer and electronics manufacturing construction that has skyrocketed due to various government incentives implemented during the pandemic.



Source: FactSet as of 18/3/24

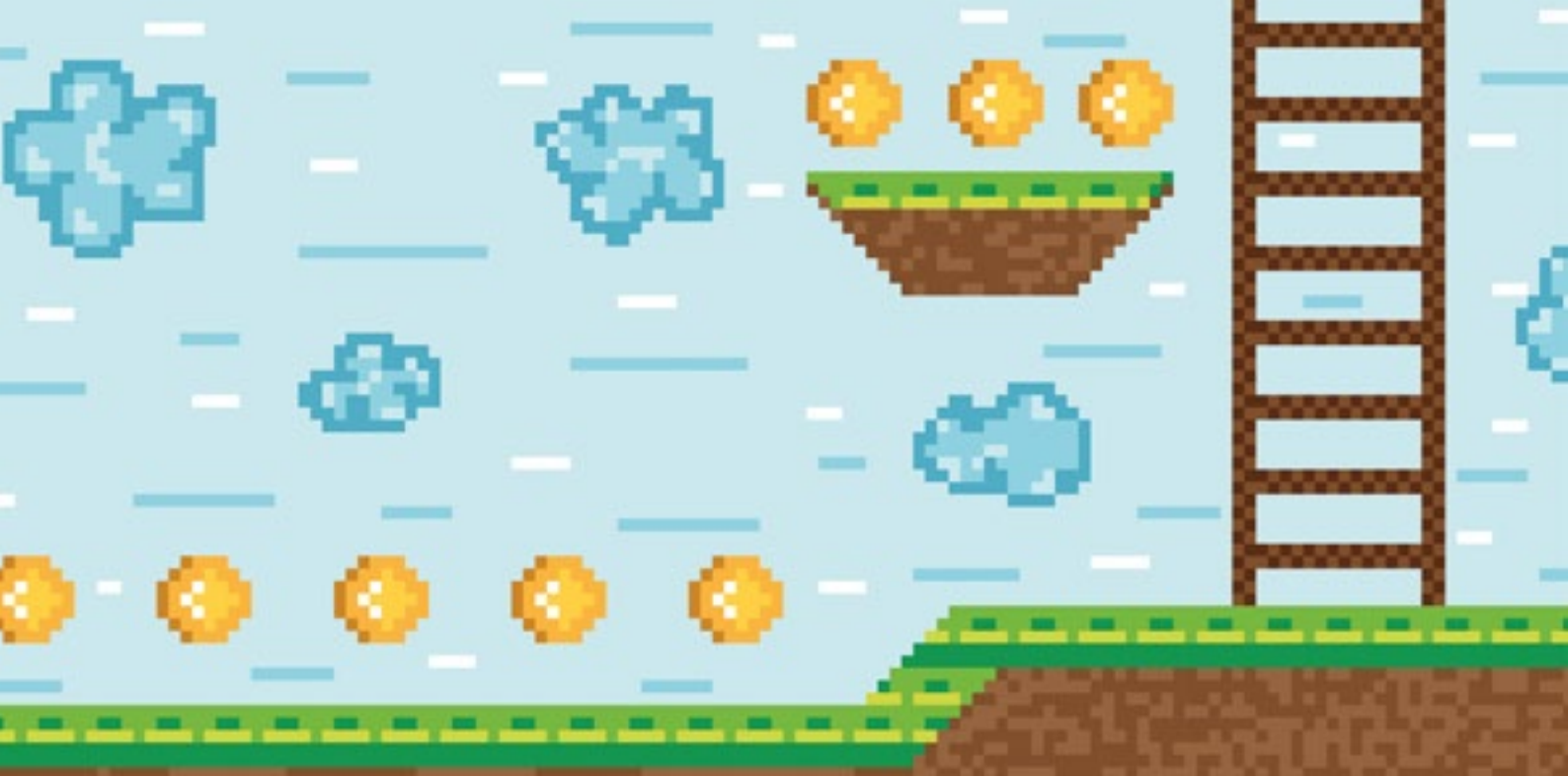
The stimulus payments in the hands of individuals and firms, coupled with the effects of the three government acts, rendered monetary policy ineffective. The Fed has increased interest rates to stall and prevent a new monetary cycle from reigniting the inflation fire, but it is currently refraining from further actions until all of these excesses are flushed out of the system.

Consequently, our outlook no longer anticipates a mild recession for the US economy. However, we still expect economic activity to slow down considerably over the next several quarters as high interest rates will continue to keep lending contained. Therefore, while our revised expectations have moved from the mildest recession in US history to a soft landing, our full-year GDP for 2024 has only moved from 1.7% to 2.0%. ▀

“Our outlook no longer anticipates a mild recession for the US economy.”

KEY TAKEAWAYS:

- Saying ‘this time is different’ is fitting in trying to understand the economy since the recovery from the pandemic.
- Inflation rose because of the collapse of global supply and supply chain issues; the increases in salaries/wages necessary to entice workers back to the labour force; and government stimulus.
- The Fed embarked on an aggressive tightening cycle in a bid to bring inflation under control.
- Monetary policy has not worked because this is not a normal monetary cycle - it is a fiscal cycle
- Government engineered industrial policy that would keep non-residential investment afloat even with high interest rates.
- While we expect economic growth to slow, we do not foresee a recession in 2024.



UK: On The Up

Professor Jeremy Batstone-Carr, European Strategist Raymond James

After two negative quarters of economic activity over the second half of 2023, the UK outlook is beginning to improve. Following two years of stagnation GDP finally contracted by 0.5% over the final two quarters of last year confirming, in so doing, the shallowest recession on record in response to the lagged impact of earlier high inflation and the Bank of England's aggressive rate hiking programme to bring those price pressures back under control. While their lingering impact continues to act as an anchor on economic activity, forward-looking business surveys are already providing a glimmer of hope that the worst of the economy's travails might now be over. Furthermore, the Chancellor of the Exchequer's March Budget delivered a net giveaway of £13.9bn (0.5% of GDP) which should help to strengthen the recovery, in the near-term at least. With inflationary pressures now on a clearly decelerating pathway, the Bank of England's interest rate-setting Monetary Policy Committee used its March meeting to deliver a heavy hint that the country's central bank is almost ready to lend a helping hand in the form of lower interest rates in coming months, easing the pressure on businesses and providing a welcome boost to households' real incomes. Reviving confidence

in the outlook is already in evidence in the financial markets. Having lagged other international stock markets over 2023, the UK's index of 100 leading companies has hit its highest levels in a year and is not far away from the all-time high levels recorded in February last year, while the more domestically focused Mid-250 Index has also delivered a spirited revival. The gilt-edged market has found the going challenging this year, after making good gains at the end of last year, but here too prospects are brightening and future investment returns are likely to be positive. Sterling has proved resilient on the foreign exchanges, in part a function of the slowly strengthening outlook and in part the market's expectation that UK disinflation will outpace that of other developed economies in the months ahead.

THE UK ECONOMY TURNS THE CORNER

After months in the doldrums, an increasing number of forward-looking business surveys are beginning to point to a slow revival in confidence in the future. While the UK economy stagnated over the past couple of years, business investment proved a beacon of light amidst the otherwise gloomy backdrop. Buoyed by an ongoing improvement in transport equipment, business investment increased by 3.7% over the year to Q4 2023 and the

promise of lower interest rates should further enhance confidence in coming quarters. More broadly, the UK's housing sector is one of the most sensitive to interest rates and here too falling mortgage rates since the start of the year signals strongly that the drag imparted by the higher interest rates of the past is beginning to fade, to be replaced by increasing levels of residential investment in coming months. Using the platform provided by the recent annual Mais Lecture in the City of London, the shadow Chancellor Ms Rachel Reeves sent a strong signal that a future Labour administration would not seek to undermine these fragile green shoots were the opposition Party to emerge victorious at the forthcoming election.

The Chancellor of the Exchequer, Mr Jeremy Hunt, delivered a modest net giveaway of £13.9bn in the 2024/25 fiscal year at his recent Budget, an easing in the near-term fiscal outlook almost entirely down to tax cuts and achievable, according to data supplied by the Office for Budgetary Responsibility, largely due to lowered market expectations for interest rates going forward. In consequence, real GDP growth forecasts were revised higher, from 0.7% to 0.8% in the current year and from 1.4% to 1.9% next year. To be clear, despite the Chancellor's overt efforts to deliver a pre-election boost to economic activity, the ongoing commitment to fiscal policy responsibility leaves an estimated cumulative £86.0bn (3.2% of GDP) of future fiscal tightening in the pipeline by 2028/29, a notable constraint on potential future policy initiatives irrespective as to which party emerges triumphant at the polls.

Were the Labour Party to win an election that must be held before end-January 2025, the shadow Chancellor has pledged a continuing commitment to fiscal policy discipline whilst nurturing the fragile green shoots of economic recovery as best it can. The job for whichever party wins the election will be made harder by the strong likelihood that the neutral rate of interest in the future will be higher than that prevailing in the period prior to the onset of the pandemic. Having averaged c.2.0% of GDP over 2010 -2019, the UK's average debt interest bill is likely to increase to around 3.0% of GDP over the next five years, a clear indication that, for whatever grandiose plans might make their way into forthcoming manifestos, the scope for a more expansionary fiscal policy will likely prove very limited. Given that all political parties have pledged ongoing support for the health service and for education, any additional expansion of the role of the state may very likely require additional tax increases to cover a further rise in spending.

THE BANK OF ENGLAND LENDS A HAND

In response to an already sharp fall in inflationary pressure from the peak levels of autumn 2022 and the prospect of a further deceleration in the very near future, the Bank of England is finally preparing the way for lower interest rates in the months ahead. At the conclusion of its March rate-setting meeting senior officials on the Monetary Policy Committee elected to hold the base rate steady for a fifth consecutive

time at 5.25%. Importantly, it accompanied the decision with the strongest signal yet that interest rates are coming down starting, if financial futures market pricing is correct, in the early summer. Three key developments underpin the growing belief that the Bank is set for turning: Firstly, for the first time since September 2021 none of the 9-member Committee voted for a rate hike (and one member is now voting for a rate cut already). Since the Bank overhauled its rate-setting process in 1997 never once has there been a rate cut when at least one member has voted for a hike. Secondly, the meeting's accompanying minutes strongly inferred that policy could be loosened even though the desired 2% inflation target has not yet been reached, providing that price pressures are deemed to be falling sustainably towards that level. Thirdly, the Bank's Governor, Mr Andrew Bailey hinted strongly in a Financial Times article that all future meetings should be considered "live", an indication that rate cuts will likely form a key focus of future discussions.

Just as significant, the first rate cut in the cycle will very likely be followed by more, perhaps down to adjusted estimates of where the future neutral rate – the level thought consistent with price stability at given levels of economic output – might be. The working assumption at this stage is that a base rate of interest at or around 3% could prove the target in 2025. Supported by an anticipated sharp fall in both services inflation and wage pressures, it is thought possible that UK CPI inflation could fall both to and then through the 2% target in the months ahead, and stay there not just through 2025, but 2026 too. Were such an optimistic outcome to be achieved it would take UK inflation well below forecast levels in both the eurozone and the United States over the same period.

AN IMPROVING OUTLOOK FOR UK FINANCIAL MARKETS

At the fact that the Bank of England is, for now, unwilling to cut interest rates has resulted in the emergence of extremely restrictive monetary conditions. Real interest rates (those prevailing after adjusting for inflation) are extremely high, imparting a significant headwind to economic activity were levels to be sustained for any length of time. That they are not thought likely to be sustained has resulted in a substantial increase in financial market speculative activity in support of the pound. This speculation has recently hit a five-year high, according to Bloomberg, a notably higher level than all other currencies featured in the analysis. Financial market pricing implies strongly that real rates (especially in relation to the United States) will both remain high and keep rising as UK inflation falls sharply over the spring. Only an aggressive rate cutting programme, such as that outlined above, could prove sufficient to topple the pound and even then improving growth prospects relative to developed economy counterparts could limit the extent of any potential weakness.

Having given back some of the gains achieved at the end of 2023, the UK's gilt-edged market is looking a much more attractive proposition

for both domestic and international investors in the light of the outlook highlighted above. The combination of sharply falling inflationary pressure and the onset of a notable and prolonged period of rate cuts should allow yields to fall sharply going forward, augmenting positive returns to investors holding broadly diversified asset portfolios.

Driven by improving investor confidence in the outlook for the UK and the global economy more generally, stock markets are likely to build on the already strong gains achieved over the past five months. The UK's leading index of 100 companies has lagged that of major developed economy counterparts, but signs are growing that that underperformance might now be coming to an end. Index constituents, heavily weighted to the Pharmaceutical, Oil & Gas, Basic Resources and Banking Sector, derive in excess of 70% of their earnings from outside the UK and would clearly benefit from a general improvement in operating conditions. The more domestically focused index of 250 companies should also encourage support given the greater cyclical and interest rate sensitive nature of many incorporated businesses.

KEY TAKEAWAYS:

- Having spent several years in the doldrums, the UK economy is slowly turning a corner. Business surveys are pointing to a slow revival in confidence in the future and households should benefit from near-term fiscal policy easing, rising disposable incomes and an improvement in the housing market.
- The Chancellor's Budget delivered a modest net give-away of £13.9bn in the forthcoming fiscal year and shadow Chancellor Ms Rachel Reeves has committed a possible future Labour Party administration to working within the constraints imposed by important fiscal discipline.
- The Bank of England, in response to an already apparent fall in inflationary pressure, with the strong likelihood of a further deceleration to come, has signalled its intention to lower interest rates before very long and once the process starts it will likely continue over the remainder of 2024 and on into 2025.
- The outlook for the UK's financial markets is improving. Sterling is well supported by rising investor conviction in improving prospects and the growing expectation that inflationary pressures will continue to fall fast in coming months. This same conviction should underpin the gilt-edged market while a steady, if shallow synchronised improvement in the global economy should provide ongoing support for the stock market.



After the Fed Pivot: Where Are the Opportunities?

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

The Federal Reserve's (Fed) pivot late last year sparked an enormous rally across all developed sovereign bond markets including, especially, that of the United States. In fact, US Treasuries and nearly all US fixed income sectors enjoyed some of their best quarterly returns on record. The sharp decline in yields over the final quarter of 2023 was a textbook reaction as market participants are well versed in what typically comes after the Federal Reserve (Fed), or indeed any central bank pivots—softer growth, lower inflation and the commencement of an easing cycle. While the timing of the Fed's easing cycle after the final rate hike varies, historically the Fed's rate cutting process has commenced an average of seven months after the last rate hike, based on the last six cycles.

With specific reference to the United States and the Fed delivering its final rate hike in July 2023, we are now approaching the historical end of the window—which has ranged from one to fourteen months—where policymakers have typically kicked off their easing cycle. Whilst notable, this cycle has been anything but average. Case in point: after 5.50%-points of tightening (one of the most aggressive cycles in history), the US economy continues to show surprising resilience—strong job growth, slowing, but still above trend activity and record low unemployment. Why? The US government's ongoing fiscal

expansion, where the deficit is now running at 6% of GDP. While the fiscal stimulus may have lengthened the economy's runway, our economist expects growth and inflation to slow over a six-to-twelve month horizon. This expected cyclical slowdown should keep investors in the US bond market focused on the timing and pace of the Fed's eventual rate cuts.

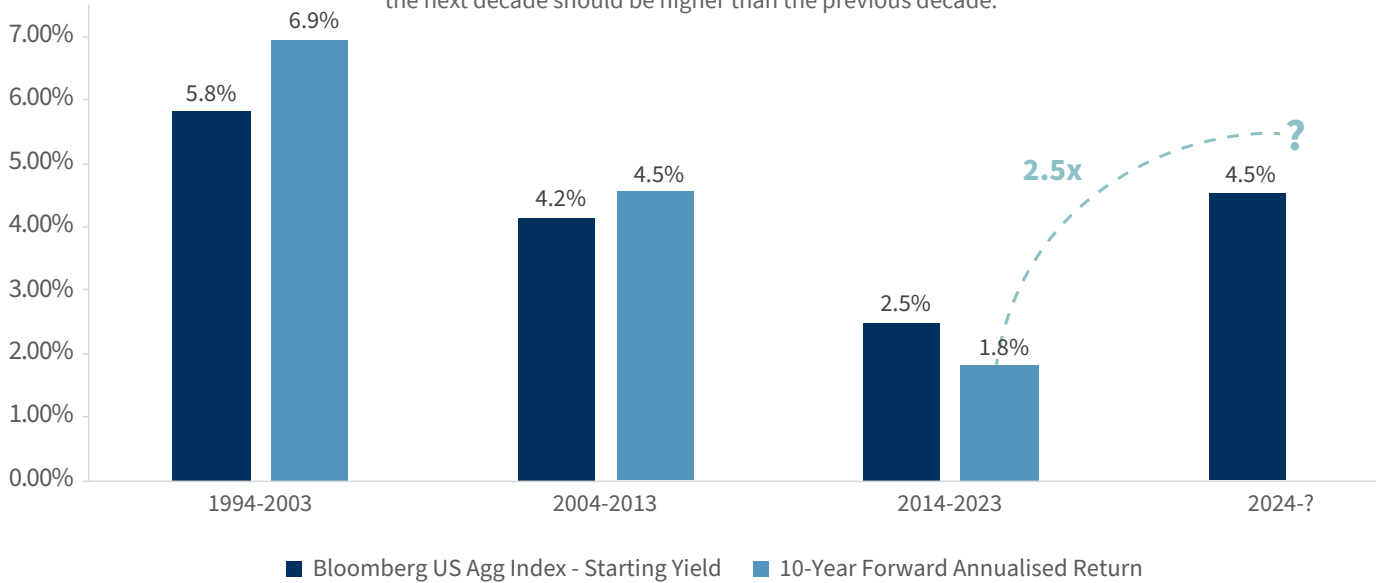
STARTING YIELDS ARE THE STRONGEST PREDICTOR OF FUTURE RETURNS

Given the macro backdrop in the United States today, there is very little urgency for the Fed to kick off its easing cycle—particularly with the economy still exhibiting signs of strength. The resilient economy has been a major factor behind why market expectations for excessive rate cuts over the coming year have largely been unwound. That's a key reason why Treasury yields have moved modestly higher since the start of the year. With the market now only pricing in three rate cuts by year end, periodic bouts of volatility could be driven by any higher than expected

The generationally high level of yields remains an attractive opportunity for investors. The starting level of yields is the single best predictor of a bond's total return over longer periods of time.

Starting Yield Best Predictor of Future Returns

The expected return a bond investor can achieve over the next decade should be higher than the previous decade.



Source: Bloomberg, as of 18/3/2024

growth or inflation readings Treasury yields will be swayed (up or down) by the incoming data. But with the Fed telling us that interest rates have peaked for the cycle and that rate cuts are on the horizon as long as the disinflationary trend remains intact, Treasury yields will eventually be headed lower—albeit likely at a slower pace than we originally anticipated. How different conditions look in the UK and Euro Area. Although sovereign bond yields in both locations have risen in tandem with those in the United States, subdued economic activity and sharply falling inflation point to notably lower bond yields over the remainder of the year.

While our call for substantially lower US Treasury yields in 2024 may be delayed as long as economic growth remains solid, we still believe the generally high level of yields remains an attractive opportunity for investors. The starting level of yields is the single best predictor of a bond’s total return over longer periods of time. And with yields across a wide spectrum of fixed income sectors and geographies significantly higher than their COVID-era lows, bonds should deliver strong returns over the coming decade. While there will be some volatility along the way, expected returns a bond investor can achieve over the next decade should be substantially higher—2.5 times higher—than the previous decade.

WHERE WE SEE OPPORTUNITIES

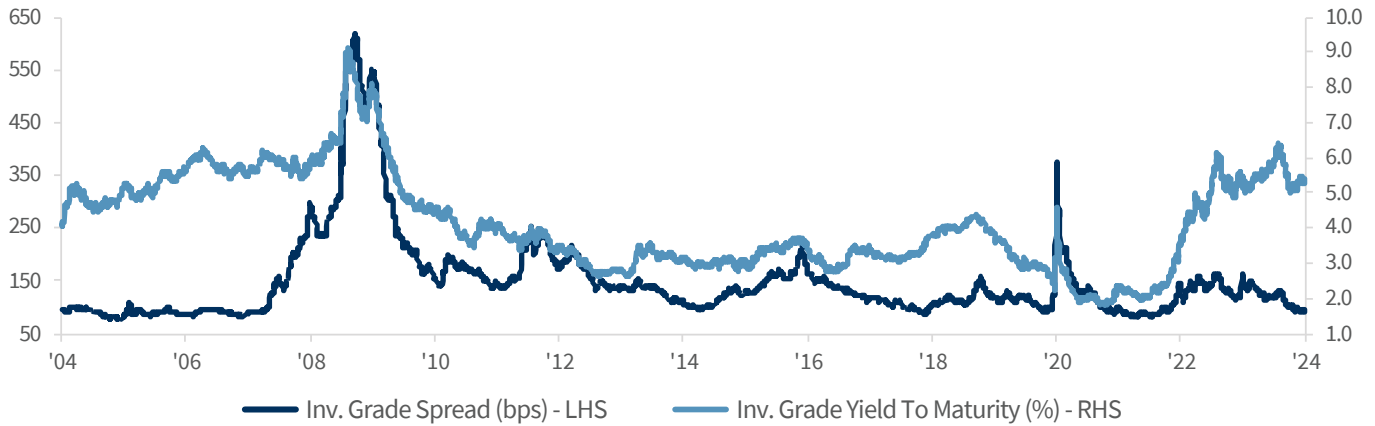
Treasury yields are likely to trade in a wide range again this year given the economy is at an inflection point. In the near-term we

Our preference remains for the higher quality sectors, which have strong debt-servicing capacity, better balance sheet liquidity to absorb higher borrowing costs, and limited default risk.

see scope for Treasury yields to move in either direction. For example, any weaker-than-expected economic news (whether on the growth, jobs or inflation front) could drive yields significantly lower as the market reprices to a more aggressive Fed easing cycle – with a move to 3.5% not out of the question. Conversely, any signs of waning demand at the upcoming Treasury auctions (2024 will be another year of heavy Treasury issuance to fund the deficit) could easily push yields higher to 4.5% again. These trading ranges should create some opportunities for investors along the way. But, by year-end, we believe that yields should be within the ballpark of where they started the year. However, with the economy still on solid footing, we are modestly raising our 10-year Treasury yield forecast to 3.75%.

Whilst equivocation regarding the near-term direction of US Treasury yields is entirely justified, it is notable that the Chief Investment Officer of the giant PIMCO (bond fund management company), Mr Andrew Balls, used a recent *Financial Times* interview to explain that from a global perspective his business was underweighting US Treasury exposure in favour of increased

Elevated Yields Are Attractive Even Though Spreads Are Historically Tight



Source: Bloomberg, as of 18/3/2024

allocations to other locations including the UK and Canada.

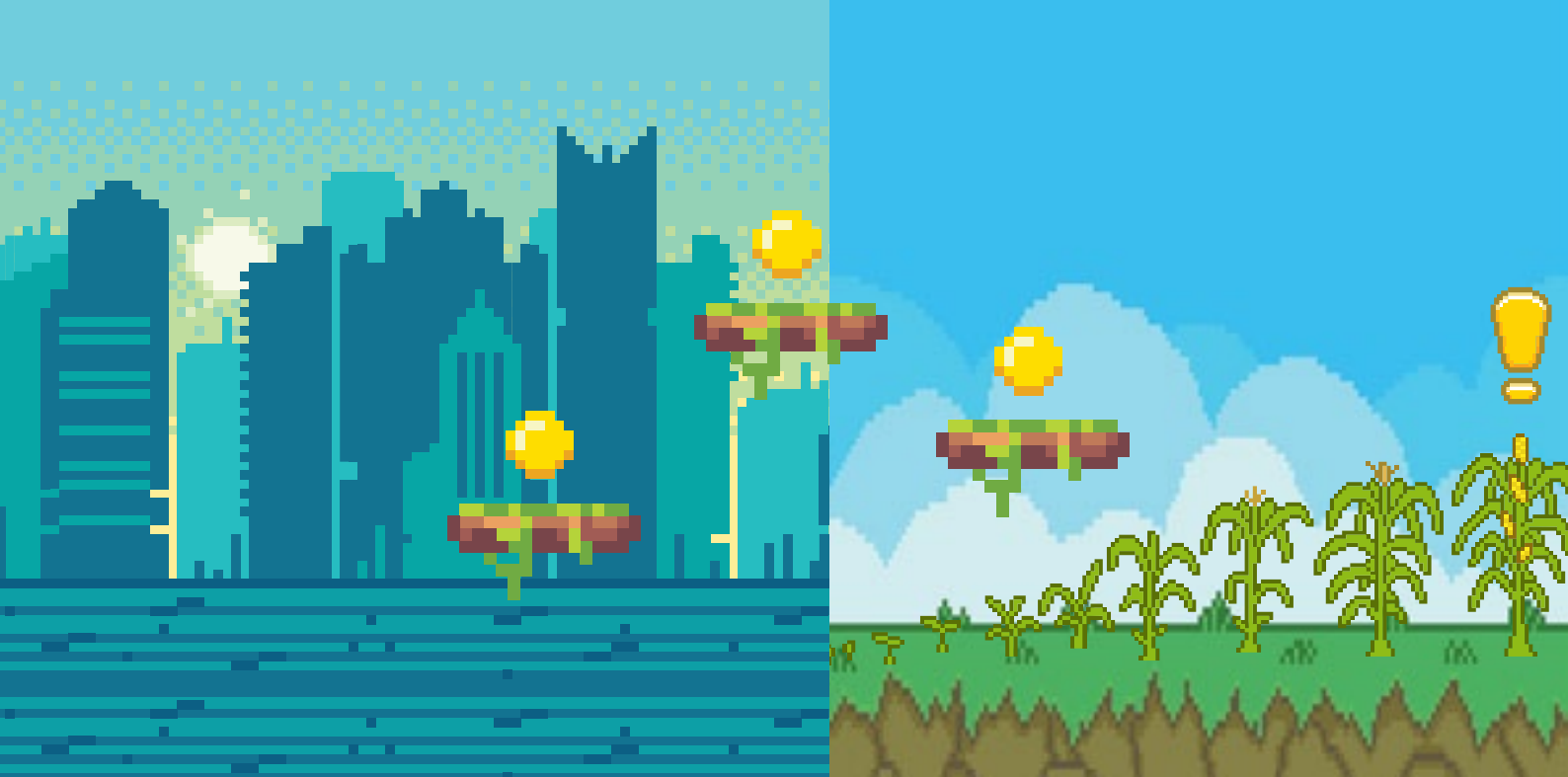
Turning to the corporate credit markets, we see limited room for further spread compression with developed market investment grade, high yield, in addition to emerging markets credit spreads trading at historically tight levels. While we do not see credit spreads being a significant driver of returns going forward, yields remain attractive and provide reasonable ‘carry’—particularly in an environment in which the global economy avoids a prolonged recession, and defaults remain low. Our preference remains for the higher quality sectors, which have strong debt-servicing capacity, better balance sheet liquidity to absorb higher borrowing costs, and limited default risk. The refinancing momentum since the start of the year should also temper investor concerns about upcoming maturity walls as corporations are, once again, staggering their debt maturities. We are also constructive on local emerging market debt as the combination of high real rates, central bank easing cycles, declining inflation and a potentially weaker US dollar should provide a tailwind to returns.

CONCLUSION

With the global central bank rate hiking cycle over and an easing cycle on the horizon, the fixed income markets are relatively attractive. Today’s yields remain near their highest levels in well over a decade, providing investors with an opportunity to lock in the current levels of yield. Capital appreciation opportunities may come, particularly if economic growth turns out to be weaker than expected in the United States while inflationary pressures decelerate sharply elsewhere. But even without the added bonus of capital appreciation, the more normal level of yields suggests investors can now earn a reasonable return on their bond investments. And that return should be much higher than that which an investor could earn in the prior decade. Relative value opportunities exist within the fixed income sectors for those looking to augment their core fixed income exposure. We recommend developed economy sovereign bonds, including gilt-edged in the UK, high-quality credits and local emerging market debt.

KEY TAKEAWAYS:

- With slow growth and rate cuts on the horizon as long as the disinflationary trend remains intact, sovereign bond yields will be headed lower.
- We anticipate that forward-looking bond returns will be much brighter than the prior decade.
- Bonds are now providing investors with healthy levels of income.



Food for Thought: Declining Crop Prices Are Helping to Alleviate Inflationary Pressures

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

What does inflation mean to you? For a typical consumer, the two most hot-button topics are food and energy. Both play a significant role in household spending, and just as importantly, both are highly visible. Petrol prices are noticed every time a driver fills up at the pump, and food prices are front and centre during every visit to a grocery store. Bearing in mind that everyone needs to eat, whereas it is almost possible to avoid spending on fuel, food tends to outweigh energy in economic importance. In the US Consumer Price Index, for example, food and energy are weighted at approximately 14% and 8%, respectively. While the media likes to write about Big Macs and cartons of eggs as indicators of food cost inflation, the building blocks of the global food chain are staple crops. Human consumers aside, some of the most important crops are also vital as animal feed. In this article, we will take a look at the world's top four crops by volume: sugarcane, corn (maize), rice, and wheat.

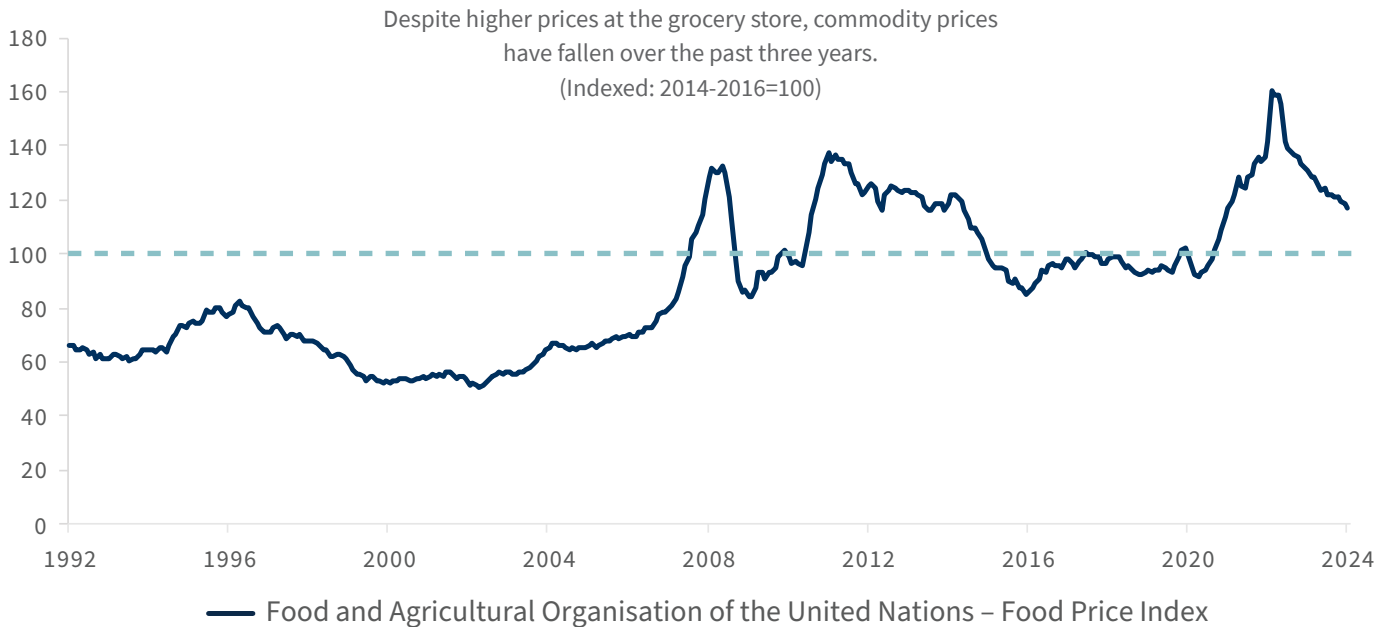
CORN PRICES: A DOUBLE-EDGED SWORD

To the extent that we think about crops, we are most familiar with

corn—for one thing, they put it in the gasoline tank! Consider this, practically all of the fuel-grade ethanol blended into US gasoline is derived from corn. Corn is also the predominant US source of animal feed. Interestingly enough, only 1% of U.S. corn supply is sweet corn, which is what's sold in the supermarket. The US is the world's largest corn producer, accounting for nearly one-third of global supply, or as much as second-ranked China and third-ranked Brazil combined. Corn prices fell this past February to their lowest levels since late 2020, around \$4/bushel, down from a high of \$8/bushel in mid-2022. This is obviously unwelcome news for farmers in the Midwest's Corn Belt, but it is good news for cattle ranchers and, by extension, anyone who enjoys a good steak. US corn plantings in 2023 were up six million acres to a near record 95 million acres—this means more supply in 2024. The US Department of Agriculture forecasts a decline to 91 million acres in 2024, which shows a response to the lower prices.

The US is the world's largest corn producer, accounting for nearly one-third of global supply, or as much as second-ranked China and third-ranked Brazil combined.

Food Prices Have Gone Down Since 2021



Source: FAO, as of 2/2024

Bearing in mind that US ethanol volumes have been flattish over the past decade, to the extent that US farmers are incentivised to produce more corn, it is to ship abroad. China is the world's largest corn importer, followed by Japan—in both countries, corn is important for animal feed. China's own corn production has plateaued, so all of its incremental demand needs to come from imports. Historically, China used to import almost entirely from the US, but that is changing. After the Chinese government approved purchases from Brazil in 2022, imports from the US fell by roughly half. While there are some political overtones here vis-à-vis the complicated relationship between Washington and Beijing, it is also a fact that Latin American corn tends to be cheaper than that which comes from Iowa or Kansas.

RUSSIA/UKRAINE & THE PRICE OF WHEAT

The wheat market has been the most influenced by geopolitics in recent years, because Russia is the world's third-largest producer, and Ukraine is (or rather was) sixth-ranked. When Russia invaded Ukraine in early 2022, wheat prices spiked to an unprecedented \$11/bushel. As with corn, prices have dropped by half since then and are currently at three-year lows—in other words, even lower than they had been just prior to the war. Recall, one of Russia's tactics in the early months of the war had been to impose a blockade of Ukrainian ports, thus halting the export of wheat. In response to intense pressure from African and Middle Eastern countries that depend on this wheat, Russia agreed to allow the resumption of Ukrainian exports in mid-2022. Although one year

“Lower food prices open the door to more discretionary spending and, at a macro level, alleviate inflationary pressures.”

later this deal fell apart, Ukraine is still exporting via the Black Sea, bearing in mind 1) the weakness of Russia's navy; and 2) it is difficult to envision the Kremlin making a political decision to attack international civilian ships carrying grain. Ukraine is also shipping some wheat overland into Europe. Although supply from Ukraine is still impacted by the war, there is no longer fear of outright shortages.

THE IMPACT OF FOOD SECURITY MEASURES

The top nine rice-producing countries are all in Asia, led by China and India. Although China produces twenty times more rice than the US, it still relies on a significant amount of imports. India, on the other hand, had historically been a rice-exporting country. That changed in 2022, when, in response to concerns about domestic food security, India's government banned the export of what's known as broken rice. In 2023, the ban was broadened to encompass plain, white, long-grain rice. In large part because of the absence of Indian rice on the global market,

current prices near \$19/hundredweight are at three-year highs and double what they were in 2020. It is understandable that India's policymakers are prioritising more supply for their own citizens, but the flip side is higher prices in China and other import-dependent countries.

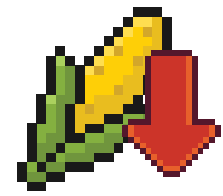
It is an underappreciated fact that sugarcane is the world's largest staple crop by volume. The sugarcane market is also interesting for the extent to which it is dominated by a single country: Brazil accounts for 40% of global production, even more than the US proportion of the corn market. Much like corn in the US, sugarcane plays a central role in Brazilian ethanol supply. Specifically, what's known as sugarcane bagasse—the fibrous, dry part of the plant—is used to generate electricity. Also, needless to say, it is hard to imagine a 21st century food system without large amounts of sugar—so much so that public health professionals have been sounding the alarm. In any case, while the sugar market has faced the challenge of periodic Brazilian droughts over the past decade, it is the second-largest producer—India—which explains why prices have doubled since 2020 to around \$0.25/pound. As was the case with rice, India banned sugar exports in 2023, which means supply from Brazil is even more crucial than before.

Putting everything together, the U.N. Food and Agriculture Organisation's Food Price Index started 2024 at 118, down 10% from one year ago, and with an even steeper decline versus 2022. Bottom line: good news for consumers. Let's underscore that food constitutes a larger proportion of spending in lower-income communities compared to wealthier ones, and in emerging markets compared to industrialised economies. Lower food prices open the door to more discretionary spending and, at a macro level, alleviate inflationary pressures and thus support monetary easing by central banks. ■

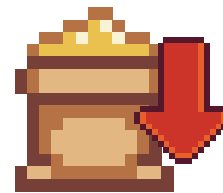
The price of staple crops has gone down.



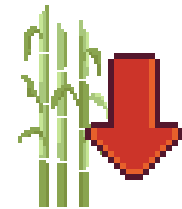
RICE



CORN



WHEAT



SUGARCANE

KEY TAKEAWAYS:

- The two most hot-button topics for consumers are food and energy—both are highly visible. Since everyone has to eat, food tends to outweigh energy in economic importance.
- The building blocks of the global food chain are the four staple crops—corn, wheat, rice and sugarcane.
- The wheat market has been the most influenced by geopolitics in recent years, because Russia is the world's third-largest producer, and Ukraine is (or rather was) the sixth. When Russia invaded Ukraine in early 2022, wheat prices spiked to an unprecedented \$11/bushel.
- Wheat prices are currently at three-year lows – even lower than they had been just prior to the war – and corn prices have also fallen sharply.
- The U.N. Food and Agriculture Organisation's Food Price Index started 2024 at 118, down 10% from one year ago, and with an even steeper decline versus 2022



Q&A: This Isn't Your Father's Index...

Matt Orton, CFA, *Chief Market Strategist, Raymond James Investment Management**

No matter where you turn, it's impossible to avoid hearing about concerns facing the stock market, from valuations to stubborn inflation to elevated rates to a lack of breadth. And it's easy to see why when looking at some of the anomalies that just keep getting more extreme. Enthusiasm around artificial intelligence (AI) and the incredible top line growth we're seeing across many of the semiconductor and software beneficiaries has led to significant price gains and consequently valuation inflation. Increasing concentration at the top of the market has also significantly narrowed the top contributors to market performance in broader indices especially, but by no means exclusively, the S&P 500, leading to extreme divergences from the average stock. Yet while concerns have been raised, notably regarding how sustained the prevailing situation might be, is this really anything new? Index concentration has always been a feature of investor exuberance. Weren't radio stocks the cutting edge tech of their day the last time the twenties roared a century ago? Arguably, more importantly beneath the surface, the market of stocks is meaningfully healthier than present day anomalies would have us believe, and there is a stealth broadening

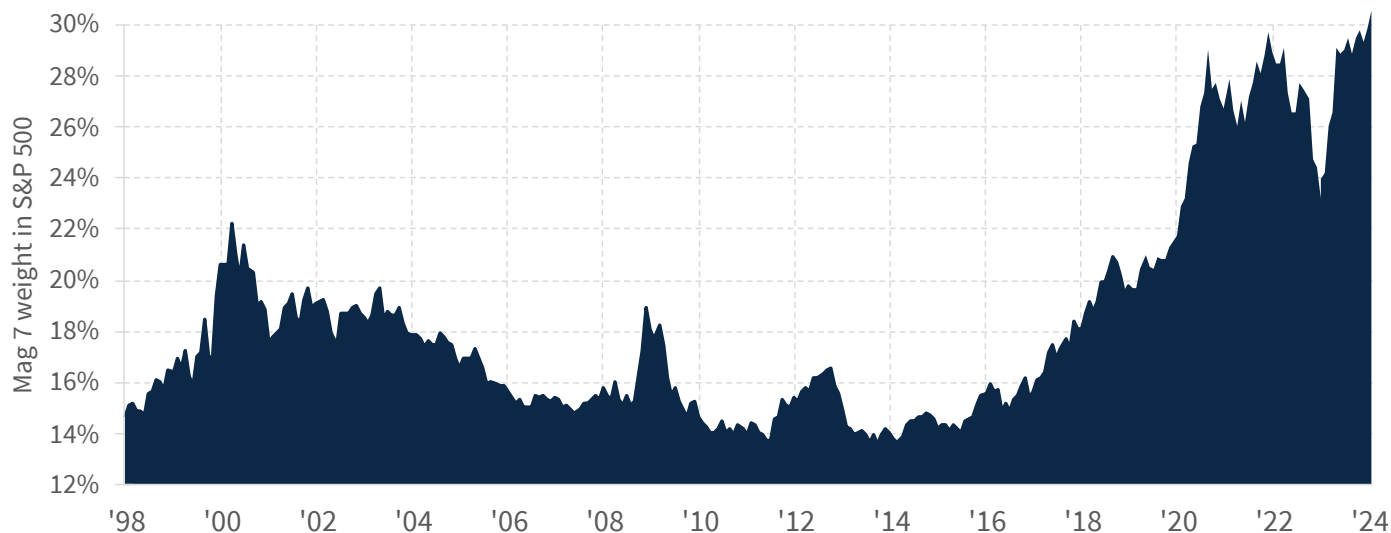
that has been, and will likely continue, taking place. This should be welcome news for investors as it is creating plenty of opportunities for those who take the time to look.

Q: What are the biggest risks from index concentration, and should investors be concerned?

A: As an index becomes more concentrated, the small handful of companies at the top will naturally have a disproportionate impact on returns. That is certainly the case right now where the 'Magnificent Seven'*** have contributed approximately 60% of the returns of the S&P 500 year-to-date, and that's after contributing over 60% in 2023. However, what goes up can also come down—and potentially these large companies might provide meaningful headwinds to index performance, just like they provided tailwinds on the way up. Part of the fear around today's market concentration is compounded by a similar narrowness in sectors and growth drivers of these top companies. Yet, while these are certainly risks, we cannot forget that many of these largest companies have incredibly well diversified businesses with a myriad of product verticals, strong earnings, and cash balances bigger than many of the constituents within the S&P 500.

Overall, heavy concentration certainly poses a potential risk, should all the giants roll over at once, but the likelihood of this is low given the current economic

'Magnificent Seven' Account for Roughly 30% of S&P 500



Source: Bloomberg, as of 18/3/2024

backdrop. Positioning might be stretched and there are risks of possible near-term pullback, but the underlying fundamentals for these companies are incredibly strong—much more so than at any other point when we’ve seen similar levels of index concentration in the past. Also, not to be overlooked, investors tend to have a recency bias and forget about the challenging 2022 many of the largest stocks experienced. In many cases, these companies have only recently moved into positive territory having suffered a torrid year immediately following the pandemic’s cessation.

Q: Is the average stock still worth owning?

A: Whilst impossible not to acknowledge some of the extreme moves this year in heavily weighted “big tech”, there are actually a growing number of stocks that are doing well, supported by strong earnings and robust fundamental outlooks. In fact, approximately 60% of the S&P 500 constituents are positive year-to-date, 35% of constituents are outperforming the Index, and nearly 30% are up over 10%. In Europe too, where the degree of equity index concentration is much lower, only around 30% of aggregate index constituents are overbought, despite equally positive returns year-to-date. Clearly, there is a lot going underneath the surface and we’ve seen a steady improvement in the absolute performance of the average stock throughout the 2023 corporate reporting season. Unfortunately, anomalies with respect to index weighting

mask this when just looking at the surface. More sectors and industries look to be approaching inflection points in their earnings cycles, in the US, Europe and the UK too, which could provide further support throughout 2024.

Q: Is index concentration making the market expensive?

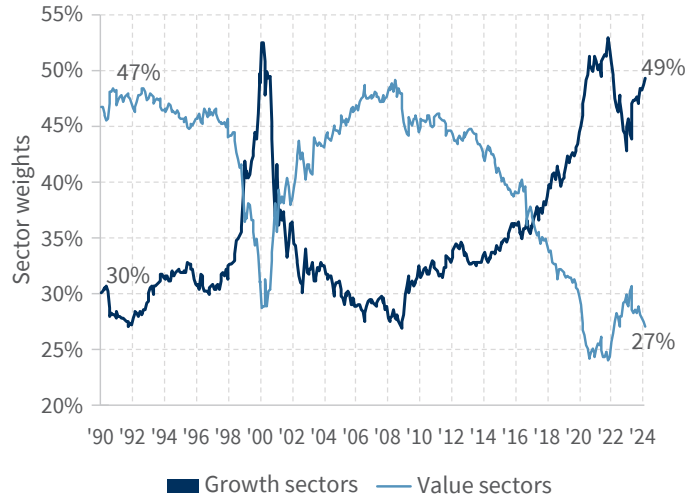
A: We need to reframe the discussion around valuation. Following an incredible ‘Fed pivot rally’ that began with Fed Chair Jay Powell’s dovish comments in December, in the United States, where the index concentration issue is most pressing, the S&P 500 is trading at 24.2x trailing twelve month (TTM) and 21.0x on a 12-month forward multiple. That’s back toward the peak of 2021 on a forward multiple basis, and the average stock (i.e., the equal weighted S&P 500) is meaningfully cheaper at 19.8x TTM and 17.4x forward P/E. With such a large gap between the Index and the average stock (five points above its TTM median P/E and three points above its median forward P/E), it’s clear that the concentration in the largest names, many of which have rallied significantly over the past year, are inflating market valuations. We see much less evidence of valuation inflation across developed stock markets outside the United States and it is worth noting that as we anticipate upward earnings revisions increases for markets generally, and an inflection across sectors ex-Technology and Communication Services, this valuation gap will likely start to shrink regardless of the market’s direction.

'Growthier' Index Demands a Higher Multiple



Source: Bloomberg, as of 18/3/2024

The S&P 500 Has a Vastly Different Composition



Source: Bloomberg, as of 18/3/2024

While it's easy to point to index concentration and generalise the market as expensive, we would push back against this notion. Is the market really expensive just because the long-term medians or averages tell us so? We would argue that the market is so different today that there isn't much value in utilising these longer-term metrics. Indeed, since the Great Financial Crisis (GFC), both the US economy and the market have become much 'growthier' in nature. Pre-GFC, sectors like Financials and Energy were among the largest weights in US equity indices, while outside the United States investors with long memories might recall the extent to which 30% of the index of the UK's leading 100 companies was comprised of Vodafone, BT and BP. That is incredibly different from today. And growth-orientated companies command a higher multiple (see chart above which tracks growth sector weights in the S&P 500 and the forward P/E). This isn't to say that the market might be stretched right now, but it's not because a historical multiple tells us so.

Q: Are there other indices that suffer from concentration issues?

A: With so much noise surrounding the S&P 500's concentration, most would be surprised to learn that a number of international indices also have pronounced concentration characteristics. In Europe, the aggregate EuroStoxx 50 Index is heavily weighted to just three businesses, SAP, ASML and Novo Nordisk. It makes sense when you think about it, right? The largest companies in the world operate internationally. The US

may boast the biggest and best technology companies in the world with the largest geographic reach, but the country does not have exclusive rights to the strongest companies in every sector. When you look at other, smaller countries than the United States, they have a fewer number of international powerhouses and thus they make up a large portion of their respective country indices. The market is the most efficient allocator—the biggest companies are the biggest because they are the best.

Q: Where should investors look to find opportunities now?

A: There are plenty of opportunities for investors who are willing to be selective - and for broadly diversified portfolios across varying geographic locations too—Industrials, Health Care, small caps and dividend growth all offer diversification appeal. Small and mid-cap biotechnology has started to outperform, driven by the Big Pharma 'obesity drug cash windfall,' while the rest of the Health Care sector is reporting earnings well ahead of estimates. Even Energy might be starting to show some signs of life outside of the refiners and the sector offers a nice complement to ever growing Technology and semiconductor weights. At the end of the day, the current manifestation of market narrowness isn't something by itself that is all too concerning, while also offering plenty of opportunities elsewhere. ■

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The Russell 2000 Index is a small-cap US stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

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Head Office: Ropemaker Place 25 Ropemaker Street London EC2Y 9LY

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