

- PAGE 1 INVESTMENT STRATEGY COMMITTEE MEETING RECAP
- PAGE 4 IT'S A SMALL WORLD
- PAGE 5 2017 THEMES TO WATCH: CHINA, TRADE & FED POLICY
- PAGE 8 STIMULUS CUT BACK: ARE THE WORLD'S CENTRAL BANKS ABOUT TO TAKE US OFF QE LIFE SUPPORT?

- PAGE 11 THE BYTE-SIZED ECONOMY
- PAGE 15 IS THE GENERAL ELECTION RESULT GOOD OR BAD FOR THE UK STOCK MARKET?
- PAGE 17 US ECONOMIC GROWTH
- PAGE 19 WILL MACRON AND MERKEL SAVE THE EU?
- PAGE 21 Q&A: THE FUTURE OF FUEL

ISSUE 10 // JULY 2017

INVESTMENT STRATEGY QUARTERLY



**2017 Themes to Watch:
Trade Policy & Central
Bank Policy** PAGE 5

**Are the World's Central Banks
About to Take us off QE Life
Support?** PAGE 8

**Will Macron and
Merkel Save the
EU?** PAGE 19

Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your wealth manager to discuss the content of this publication in the context of your own unique circumstances. Published July 2017. Material prepared by Raymond James as a resource for wealth managers and investors.

RAYMOND JAMES®

INVESTMENT STRATEGY COMMITTEE MEETING RECAP – HELD ON JUNE 7, 2017

Major macro factors affecting the economy and financial markets over the next six to 12 months include earnings growth, Federal Reserve policy, economic growth and U.S. political uncertainty.

U.S. ECONOMY – Scott J. Brown, Ph.D., Chief

Economist, Equity Research

The majority of the committee is neutral (1.5 - 2.0%) to somewhat positive (2.1 – 2.5%) on real U.S. GDP growth over the next six to 12 months. Inflation is estimated to remain about the same at 1.5% for the same timeframe.

- “It looks like the big rebound in growth that we anticipated in Q2 is going to be a bit softer than we thought, particularly in consumer spending. It’s still going to be stronger than in the first quarter, but not by a lot.”
- “Tax reform is difficult, but Washington is still likely to lower tax rates. Even if we were to get the full Trump agenda, the job market will be a binding constraint on the pace of economic growth.”
- “Nonfarm payroll figures bounce around from month to month, but there is a clear downtrend over the last couple of years. We’ve also had four consecutive monthly declines in retail employment, which is worrisome, but the unemployment rate continues to fall.”
- “In June, the Federal Reserve (Fed) will raise the target range to 1 - 1.25%. With the 2-year Treasury yielding 1.31%, the market doesn’t seem to expect many more rate hikes beyond that – a contrast to the Fed’s outlook.”
- “The Fed is expected to start unwinding its balance sheet by yearend, but should begin cautiously and I think the markets should be okay with that.”

INTERNATIONAL – Chris Bailey, European Strategist, Raymond James Euro Equities*

There was a significant increase in the bullishness of the committee towards foreign equities this quarter. 89% are neutral to bullish towards non-U.S. developed equities and 81% are neutral to bullish towards emerging market equities over the next six to 12 months.

- “Brexit is a multi-year event. Increasingly, it looks like a three-to-five year time horizon for the legislation to be completed. Although there is currently a two-year window for negotiations, there is increased talk of transitional arrangements driven by the perspective that Brexit will be delayed. More importantly is what’s going to happen with ongoing economic reform.”

- “The biggest wildcards for 2018 will be the results and impact of the German elections (held in late September 2017), the progress in reforms and if Brexit negotiators will be pragmatic.”
- “In France, President Macron has all the building blocks required to start making some changes, albeit slowly. Although there are questions around his ability to implement the changes he is proposing, the circumstances are the best they’ve been for many years now.”
- “There is a bit of momentum with positive earnings growth and money inflows to the European financial markets, which has been pushing the euro up and giving people some faith. If you are thinking about allocating to Europe, it still makes sense.”
- “China’s Belt and Road initiative is about more than economic growth. It’s about trade and diplomacy. It’s an old trade route reconfigured for the modern day world. People have noted some similarities to the Marshall Plan of the post-World War II era in terms of the size, scale and potential diplomatic influence – it’s something to watch.”

U.S. EQUITY – Andrew Adams, CMT, Senior Research Associate, Equity Research

The majority of the committee is neutral to bullish on U.S. equities over the next six to 12 months, a little lower than in the recent past. More than 80% of the committee thinks there is a good chance for a pullback in that same timeframe.

- “We still think it’s a bull market. There’s a relatively high floor to how low stocks could go.”
- “We’ve had the best pace in earnings growth since 2011, and the market has responded very well to that. The market still seems to be shrugging off all political issues, and it’s more focused on earnings despite softening economic growth.”
- “Technology is expected to be one of the best areas for growth over the next few years; however, it’s currently overbought and overextended. The dips are still for buying, for technology and the market as a whole.”
- “It’s all about earnings until proven otherwise.”

FIXED INCOME – Nick Goetze, Managing Director, Fixed Income Services (unless otherwise noted)

Twelve months from now, the majority of the committee thinks that rates on the 10-year Treasury will be moderately higher.

- “Demographics are going to play a huge role over the next 10 to 15 years as baby boomers go through the natural progression of shifting from heavily allocated risk-based assets to safer, higher credit quality, income-producing assets.”
- “An effective strategy to buffer against an equity market pullback or recession could be long duration, high credit quality, fixed income assets.”
- “The Treasury curve has been flattening since 2014 and the runway is getting short for the Federal Reserve. The bond market continues to tell us that what’s going on in the markets is relatively uncertain.”
- “Last quarter, municipal bonds were cheap and they’ve rallied considerably, although there’s not a lot of supply. Munis have shown the resiliency that we’ve come to expect out of them, which is encouraging and reinforces slow, steady, low inflation.”

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

- “The bond world is focused on the Federal Reserve. The global balance sheets are still expanding, so you’ve got room to run in Treasuries.”

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

CREDIT MARKETS – James Camp, CFA, Managing Director of Fixed Income, Eagle Asset Management*

The U.S. market for credit continues to attract large flows from institutions and individuals. Record tax receipts at the state levels and pension underfunding are adding to demand in an already yield-starved environment.

- “It’s hard to be bearish on equities when the credit markets are giving away money. It’s just that simple.”
- “The new issue bond market is frequently oversubscribed. Spreads move in from initial price talk and tighten after issuance.”

- “It is an uncomfortable calm, and low interest rates have modified behavior of issuers and investors. The bull market for risk assets is, at least in part, being enabled by the credit markets. Until this appetite is satiated, risk assets will benefit and low volatility will persist.”
- “At least from the credit side of the ledger, stability is inherently unstable.”

ENERGY AND OIL – Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research

On the whole, commodities have been fairly soft. Energy is part of that trade, not exclusively oil. Oil demand is relatively healthy, growing at about 1% per year.

- “We have been frustrated and perplexed by the disconnect between the fundamentals of the oil market and current price levels. A classic example is oil falling 5% in response to OPEC’s recent news of extending production curtailments.”
- “To grow the global oil supply 1% per year, the current level of drilling activity isn’t enough. Prices will have to rise to enable the industry to get to a more sustainable level of investment. Over the next three to six months, as the inventory data becomes more durable, that should happen.”
- “Despite all the hype over President Trump’s announcement to pull out of the Paris agreement, the actual trend of lower carbon emissions and changes in the production and consumption of energy is going to continue – in the U.S. and countries that have stayed under the Paris framework.”
- “Even more influential is the change in the economics of electricity generation. Natural gas is gaining share, and wind and solar are gaining share at an even faster rate.”

Investment Strategy Committee Meeting Recap continued overleaf: Alternative Investments and Asset Allocation >>

INVESTMENT STRATEGY COMMITTEE MEETING RECAP – CONTINUED

ALTERNATIVE INVESTMENTS – Jennifer Suden, CAIA,
Director of Alternative Investments Research, PCG
Investment Products

In 1Q 2017, industry net outflows, driven by the challenging environment for alternative investments when compared to equity market performance, slowed to the lowest level in five quarters.

- “The majority of the hedge fund industry inflows (within private hedge funds) went to global macro and event driven hedge funds. I think people are realizing that dislocations are occurring across the global market environment.”
- “Mainly, we are seeing continued interest in private equity, and a lot of that has to do with the return-enhancing properties of those strategies.”

ASSET ALLOCATION – Kevin Pate, CAIA, Vice President, Asset Management Services

Valuations across all asset classes continue to grind higher. In the equity space, multiples are creeping up, and, in the credit space, spreads continue to narrow.

- “For implementations where we can own alternatives, we remain underweight equity. Within alternatives, we support trend-following strategies to help meet downside risk targets and protect against higher drawdowns. We remain neutral to emerging markets.”
- “Within fixed income, our views continue to evolve. We remain underweight duration but want to continue to chip away at that underweight going forward.”

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

Andrew Adams, CMT, Senior Research Associate,
Equity Research

Chris Bailey European Strategist,
Raymond James Euro Equities*

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

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

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

Doug Drabik Senior Strategist, Fixed Income

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

Nick Goetze Managing Director, Fixed Income Services

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

Nicholas Lacy, CFA Chief Portfolio Strategist,
Asset Management Services

Pavel Molchanov Senior Vice President,
Energy Analyst, Equity Research

Kevin Pate, CAIA Vice President, Asset Management
Services

Paul Puryear Director, Real Estate Research

Jeffrey Saut Chief Investment Strategist,
Equity Research

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

Benjamin Streed, CFA Strategist, Fixed Income

Jennifer Suden, CAIA Director of Alternative Investments
Research

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

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

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

All expressions of opinion reflect the judgment of Raymond James & Associates, Inc., and are subject to change. There is no assurance that any forecasts will occur. Investing involves risk including the possible loss of capital. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. The market value of bonds may be affected by several risks including interest rate risk, default or credit risk, and liquidity risk. Asset allocation and diversification do not guarantee a profit nor protect against loss. Companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence.

It's a Small World ...

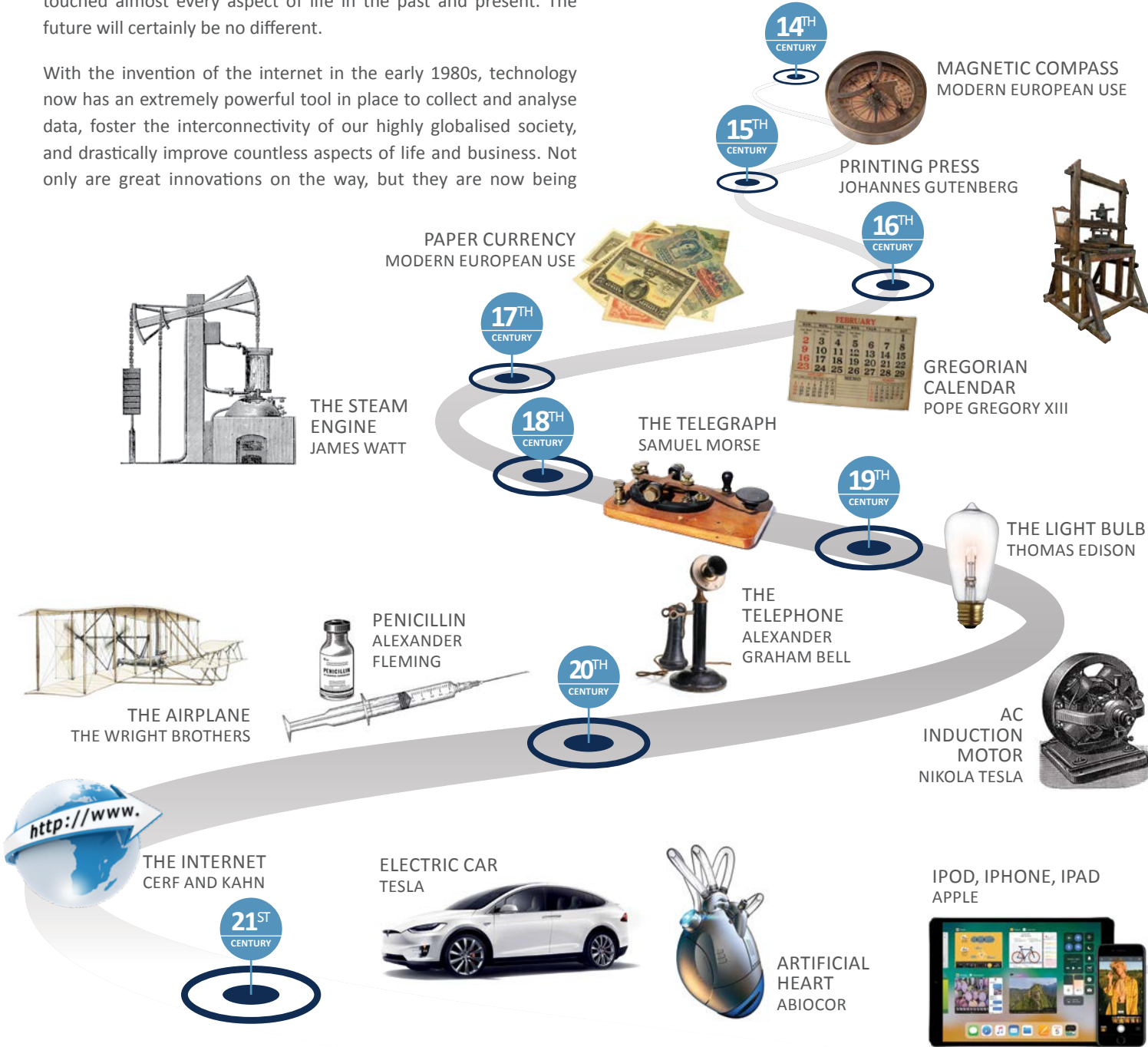
Kristin Byrnes, Committee Vice-Chair, Product Strategy Analyst, Wealth, Retirement & Portfolio Solutions

Innovation and technology have been propelling society forward since the discovery of fire, as curiosity compels us to solve problems and improve efficiencies. We are naturally inclined to question the status quo, search for answers, and find solutions to challenging setbacks. This natural inclination has led to advancements throughout the history of humankind that have exponentially changed the way we live our day to day lives. Whether it's Johannes Gutenberg's printing press, Thomas Edison's lightbulb, or Alexander Fleming's discovery of penicillin, technological advancement has touched almost every aspect of life in the past and present. The future will certainly be no different.

With the invention of the internet in the early 1980s, technology now has an extremely powerful tool in place to collect and analyse data, foster the interconnectivity of our highly globalised society, and drastically improve countless aspects of life and business. Not only are great innovations on the way, but they are now being

developed more quickly and more cheaply than ever before. The next couple of decades are likely to deliver some major advancements, many of which are inconceivable at the moment. This quarter's issue of *Investment Strategy Quarterly* dives into how technology is changing major industries, financial markets, and the global economy.

A LOOK BACK BY CENTURY



2017 Themes to Watch

ECONOMIC GROWTH: TRADE POLICY



Is China the new champion of globalization? They may be leading the way for the global economy, and these insights share how. China's economic development over the last generation has been staggering. The recent announcement of over 40 international-contracted projects in 60 countries along the Belt and Road Initiative route worth a cumulative \$90 billion is striking ... and potentially very economically dynamic.

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

The Chinese people refer to their own country as “zhongguo,” which directly translates to “Middle Kingdom.” Around 3,000 years ago, the Chou people adopted the belief that their empire occupied the middle of the earth, surrounded by barbarians. Back then, the Chou people would have been astonished at the simultaneous development of the Greek and subsequently Roman Empires, but, in their splendid isolation, the phrase stuck.

A BURGEONING INITIATIVE

Returning to the modern world, China has steadily increased its share of global economic interaction over the last 30 years. The World Bank and International Monetary Fund now show China's share of the global economy at 17.2% (in real GDP terms), exceeding the United States' equivalent statistic of 15.7%. Such is the benefit of a population of well over a billion people and a progressive series of economic reforms over the last generation that have seen a largely agrarian economy become the world's manufacturing powerhouse. In regard to the latter, the economy has been augmented by policy initiatives designed to expand consumption and the service sector.

These changes have given the country a new political and diplomatic confidence that would have been alien to the inward-looking Chou people, or even the first 50 years of Chinese Communist Party leadership. President Xi Jinping's inaugural appearance at the World Economic Forum in Davos, Switzerland, occurred the same week as the inauguration of President Donald Trump. Xi's message of “whether you like it or not, the global economy is the big ocean you cannot escape from” has been followed up by an even bigger global economic and trade play: the Belt and Road Initiative, a modern reworking of the old Silk Road trading route between China and Europe.

China's economic development over the last generation has been staggering. The recent announcement of over 40 international-

“A lot of people, including business leaders, think the future belongs to China. Globalisation is not a zero-sum game, but we need to hone our skills to stay in play.”

– Jon Meacham

contracted projects in 60 countries along the Belt and Road Initiative route worth a cumulative \$90 billion is striking ... and potentially very economically dynamic. This was supplemented by the Middle Kingdom signing bilateral investment treaties with 104 countries involved in the Belt and Road Initiative and gives a feel for its potential medium-term significance.

The economics and politics of geography and topology are absolutely fascinating. Centuries ago, the Silk Road trading route was, for a long time, the only link between a distant Western Europe and a distant East Asia, with its path defying all terrain supremely dangerous and difficult to traverse. Modern transportation by sea and air provide alternatives, but land-based road and rail will inevitably bear the biggest burden. So, any modern infrastructure benefits that can facilitate this more easily is a win-win, and the Chinese understand this.

DEALING WITH TRADE

Of course, none of this is done out of pure charity. It makes complete sense for an evolving Chinese economy to engage with the rest of the Eurasia land mass to trade more and generate mutual wealth. The difference is China's pre-eminent role in driving such engagement ... and that I have not mentioned the United States once in the last three paragraphs.

There will be many twists and turns in the foreign policy initiatives of the United States, but it is likely that a “fair trade” rather than “free trade” focus will be central. A quick glance at average tariff levels

“The Chinese are still in building mode, and this means championing, not blowing up, global trade flows.”



“China’s Belt and Road initiative would have an underappreciated uplifting effect on many of the emerging markets.”
— Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research

shows China imposing much higher barriers than either the United States or Western Europe. Globalization by China has some distinct differences, and an expectation that tariff levels will be sharply and rapidly reduced to the levels seen in these other geographies is probably wishful thinking.

“Capitalism with Chinese characteristics” is an evolving reality, but just like the “dollar diplomacy” of yesteryear, money always talks, especially in many poorer and/or significantly smaller Asian nations that increasingly rely economically on China. Expect Chinese globalization to be suitably mercantilist in nature; to help generate surpluses, keep the domestic nation state strong, and build power and influence to support these objectives.

However, before we slide into loose talk about emerging trade blocs and material interruptions to the current level of trade flows, remember this: the Chinese economy is currently undertaking a lot of transitions, and stability remains the most prized characteristic for its political leadership. The Chinese are still in building mode, and this means championing, not blowing up, global trade flows. However, in another decade or so, matters may be different, giving the United States a window of opportunity. Is it time to force change, or just live with changes over time from the East? ■

2017 Themes to Watch (cont.)

US CENTRAL BANK POLICY



With the US job market nearing full employment and inflation showing signs of picking up, Federal Reserve (Fed) officials are more comfortable with a pace of rate increases that is still gradual, but less “glacial.”

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

Since taking over as chair of the Fed, Janet Yellen’s primary goal has been to normalize monetary policy. The Fed lowered the federal funds target range to 0 - 0.25% in December 2008, and held it there for seven years. As the Fed initially raised the target range in December 2015, officials generally expected to raise rates four times in 2016. A slowing in the pace of job market improvement and a more modest inflation outlook countered those expectations, and the Fed raised short-term interest rates only once that year, in December. This year, Fed officials are more comfortable raising rates, but it should still be a gradual pace.

Inflation figures are often a bit choppy in the first few months of the year. Many firms will try to raise prices to see if they stick. That may have been the case in January and February. Core inflation was mild in March and April, partly reflecting an unusually large one-time drop in the price of wireless telecom services. Reflation expectations in commodity prices have softened in the last couple of months (outside of oil prices, it takes a gigantic increase in the price of raw materials to have much of an impact at the consumer level). While factory sector activity has improved, we are seeing few signs of the type of bottleneck production pressures that would lead inflation higher; by contrast, we are still seeing mild deflation in prices of consumer goods excluding food and energy. The labor market is the widest channel for inflation pressures, and wage growth has remained generally moderate.

The US job market has been the primary focus for Fed policy. It’s unclear how much slack remains, but the broad range of indicators suggests that we are at or near full employment. Monetary policy is still accommodative. Hence, the Fed wants to move closer to a “neutral” policy position. The best analogy is that the central bank is not hitting the brakes so much as gradually taking the foot off of the accelerator.

During the financial crisis and its aftermath, the Fed increased the size of its balance sheet by more than \$3.5 trillion through its three large-scale asset purchase programs. The Fed has been reinvesting principal payments (maturing Treasuries and mortgage-backed securities), keeping the size of the balance sheet steady, but officials expect to change the policy later this year. The Fed will set a \$10 billion cap, or limit, on the dollar amounts of Treasury and agency securities that will be allowed to run off each month (\$6 billion for Treasuries, \$4 billion for MBS), and only the amounts of principal payments that exceeded the caps would be reinvested. The caps will be increased every three months, eventually reaching \$50 billion per month. The Fed reserves the right to resume the reinvestment policy or to increase the size of the balance sheet if economic conditions warrant.

The end of the reinvestment policy should not be unsettling for the financial markets, but there is some potential for confusion. Recall the “taper tantrum” turmoil of 2013, when long-term interest rates shot up on concerns about the Fed scaling back the pace of asset purchases in the third round of quantitative easing. By starting slow, markets shouldn’t become unsettled, and officials will be able to observe how the markets react as the balance sheet drawdown increases.

Of course, none of this is written in stone. Fed policy will adapt to changing conditions. There is one additional caveat. The Fed’s Board of Governors will see a lot of personnel changes in the coming months, adding some uncertainty for the financial markets. ■



Stimulus Cut-back: Are the World's Central Banks About to Take us off QE Life Support?

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

"There is no stimulus like that which comes from the consciousness of knowing that others believe in us"
Orison Swett Marden

Over the last eight-and-a-bit years, unorthodox quantitative easing policies have become the central tenet of policy-making by the leading central banks of the world. The notion of printing money to buy government bonds, with the aim of stimulating the local economy, shifted from economics text books to actual policy as a temporary source of monetary policy stimulus to back up ultra-low interest rates. But what was dubbed temporary has, until very recently, had a semi-permanent look as leading central banks concluded that such instruments still had a relevance in today's economic backdrop.

Recently however, a change in central bank communication has occurred. Unsurprisingly, this started with the Federal Reserve of the United States, which was not only one of the earliest to adopt unorthodox policies, but in terms of resulting economic growth over the last few years has been one of the most successful in creating a positive impact. The surprising words of Janet Yellen, the Chair of the Federal Reserve, at her June press conference, outlining the likely multi-year reduction of the quantitative easing boosted Federal Reserve balance sheet, came at least six months before most commentators thought she was likely to opine an opinion.

Due to the early nature of their quantitative policy implementation, the Federal Reserve did have some clear decisions to make, in both 2018 and 2019, as to whether they wanted to 'roll over' all of these bonds or not. The comments of Janet Yellen suggest that this is unlikely, and the Federal Reserve's balance sheet will start to materially contract next year.

The notion of printing money to buy government bonds, with the aim of stimulating the local economy, shifted from economics text books to actual policy

Such a move implies a confidence about the current status of the American economy, a feeling deepened by the three interest rate rises sanctioned by the Federal Reserve in the last eight months, albeit that policy remains very loose compared to the norm of the last couple of generations. Policy remains very loose elsewhere too, and whilst the size of central bank balance sheets are still expanding in countries like the UK and Japan, as well as in the European Union, talk about the limits of central bank stimulus efforts appear legion. At one well-known economics conference, at least three central bankers from different geographies expressed similar opinions about reaching the upper bound of efforts, an occurrence which has made many observers conclude such communications are co-ordinated.

Stimulus Cut-back: Are the World's Central Banks About to Take us off QE Life Support? (cont.)

| G4 CENTRAL BANK BALANCE SHEET (FULL YEAR CHANGE IN BILLION US DOLLARS) | | | | |
|---|-------------|------------|-------------|-------------|
| | 2017e | 2018e | 2019e | 2020e |
| Federal Reserve | -3 | -336 | -483 | -378 |
| European Central Bank | 1049 | 102 | -96 | -75 |
| Bank of Japan | 954 | 454 | 91 | 23 |
| Bank of England | 50 | 14 | 15 | 15 |
| Total | 2050 | 234 | -473 | -415 |

Source: BoA-ML

Communication – rather than explicit forecasts or guidance – is a much used weapon by central banks wishing to test out the sensitivity of financial markets to various potential policy instruments. Judging by the rise in bond yields (i.e. the fall in bond prices) that has occurred since this communication exercise commenced, there is a sensitivity – and quite rightly so. Government bond markets have become more dominated by central banks, and the extremity of the Japanese government bond market – which

essentially did not trade for over a week due to the sheer dominance of the local authorities – reflects this better than anything.

Japan is the poster child for what happens if stimulus becomes too fixed. Over a quarter of a century since the Japanese market peaked, the difficulties of the Bank of Japan, and their government cohorts the Ministry of Finance, to raise headline inflation or inflationary expectations remains a clear warning to other major global central banks. As is often the case with too much of anything, the marginal impact gets ever diminished – and even outside of Japan the apocalyptic fears of many monetarist thinkers that material quantitative easing would inexorably led to high inflation has proved incorrect. We can thank the continued fall in the rate money circulates within the economy for this latter occurrence, but it raises an interesting point. Quantitative easing helped stop the rot emanating from the 2007-8 global financial crisis, but it is of little new extra use. By contrast, other policy forms – for example supply side reform to increase demand and boost dynamism, flexibility and productivity through tax reforms, infrastructure

Whilst the size of central bank balance sheets are still expanding in countries like the UK and Japan, as well as in the European Union, talk about the limits of central bank stimulus efforts appear legion



plans, labour market changes and related – may now make more sense in the policy bucket. Central banks may exhort on these areas, but it is governments who draft legislation and enact policy here.

So how is this all going to pan out? My conclusion would be that quantitative easing as we know it has peaked and all major central banks – with the possible exception of Japan – will be contracting their balance sheets within a couple of years, following the guidance lead by the United States. However as a quid pro quo, all this means is that interest rates will remain low as central banks respond to still low inflation, and a fear that policy makers may be ineffective in enacting supply side reform and change.

A cynic would say this is just swapping one form of stimulus for another. At a certain level, this is true. However our debt heavy, deteriorating demographic profile world continues to need help. If policy makers have a similar sense of purpose that central bankers generally have had in the last eight or nine years, the global economy, equity markets and corporate earnings have nothing to fear from the shift to more supply side centred stimulus. By contrast, over time in this scenario, interest rates and bond yields will return to more normal levels.

In short, for risk-embracing assets, you should not be overly worried about the slow wind down of quantitative easing stimulus by central banks so long as you have faith in the supply side reform programmes in America, Europe and China among others. ■

Quantitative easing helped stop the rot emanating from the 2007-8 global financial crisis, but it is of little new extra use

KEY TAKEAWAYS:

- The Federal Reserve started a trend for central banks to talk more cautiously about further QE expansion
- Japan indicates that long-held faith in QE is not wise
- Anticipate over time central bank balance sheet sizes to fall
- With supply side policy increasingly taking the strain, the question is how successful can governments / policymakers be implementing these necessary reforms



The Byte-Sized Economy

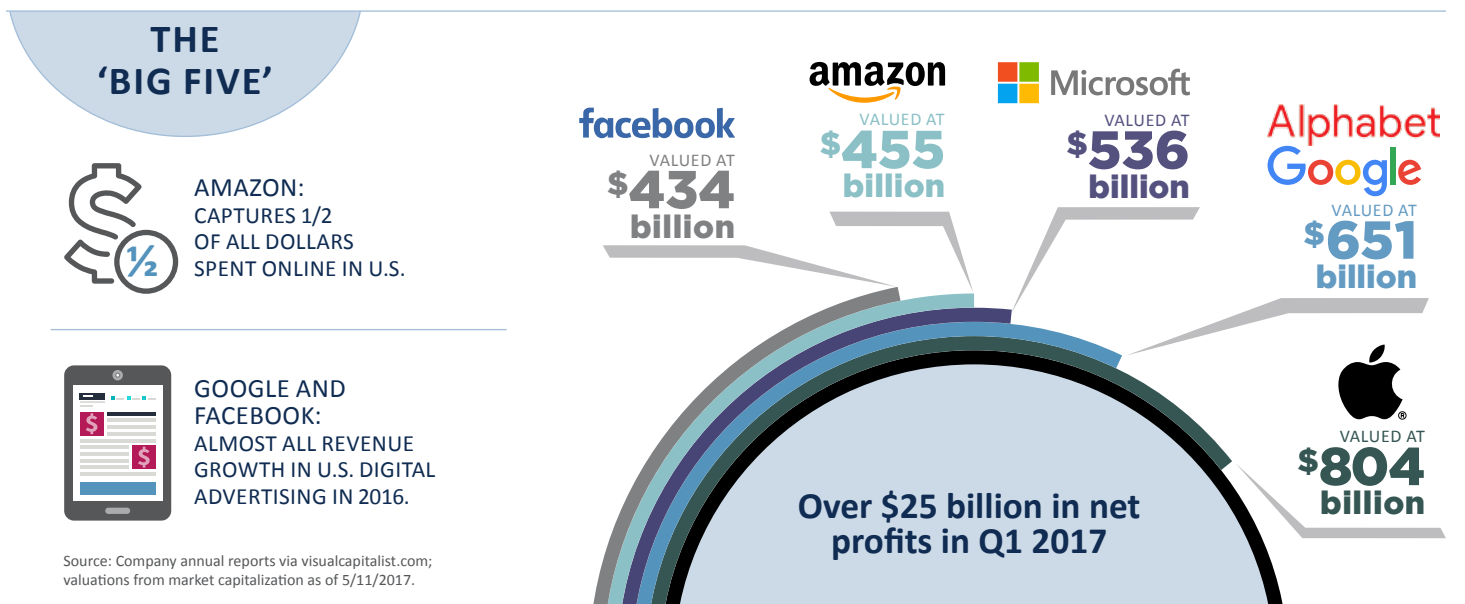
Andrew Adams, CMT, Senior Research Associate, Equity Research, discusses how the increasing connectedness of data and technology are shaping our economy.

The 2014 Christmas episode of Netflix’s *Twilight Zone*-style series, *Black Mirror*, eerily presented a near-future world where tiny, portable devices can be implanted into the heads of willing consumers to collect all kinds of data. That data is then used to create digital ‘cookies’ of the participants that can automatically control many aspects of daily life – from making toast each morning just the way you like it to managing your entire ‘smart home.’ To some, this *Jetsons*-esque level of technological involvement is frightening, while others see it as the natural evolution of our increasingly connected society. Like it or not, it does appear to be the direction our world and, by extension, our world economy is headed – and it’s probably going to happen much sooner than most believe.

THE FUTURE, TODAY

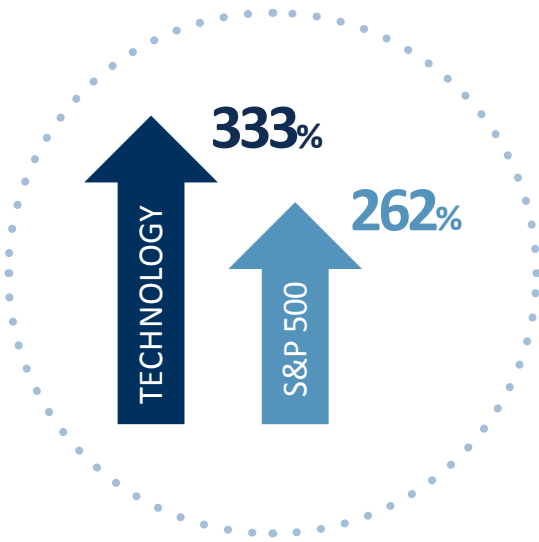
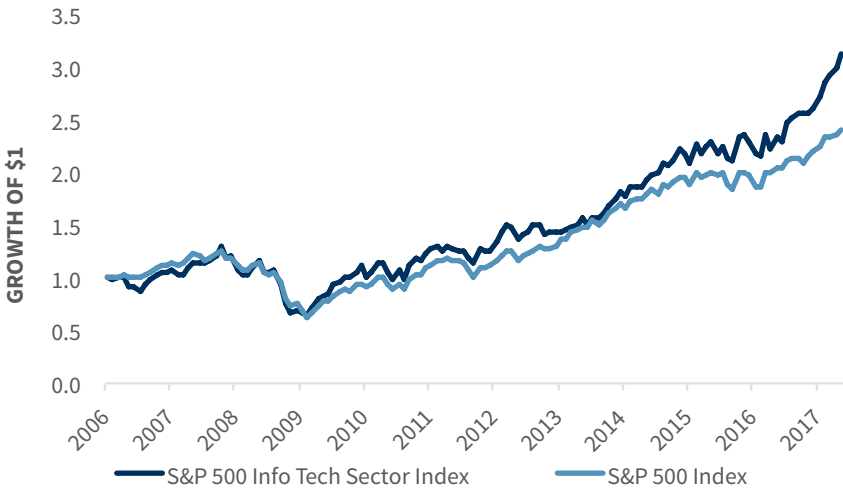
Of course, in some ways, the future is already here. The five most valuable publicly traded companies in the world from a market capitalization perspective – Apple, Alphabet (Google), Microsoft, Amazon and Facebook – are all firmly entrenched in the technology realm. In just a few short years, these tech titans have become essential, integrated parts of our lives, and that dependence is likely to become even more pronounced as their services continue to get more powerful and personalized. The tremendous growth of

big tech is not a case of unjustified expectations either, since investors recognize that real value is already being produced. A recent article in *The Economist* nicely summarised the importance of the ‘big five’ by noting, “Their profits are surging: they collectively racked up over \$25bn in net profit in the first quarter of 2017. Amazon captures half of all dollars spent online in America. And Google and Facebook accounted for almost all the revenue growth in digital advertising in America last year.”





S&P 500 TOTAL RETURN GROWTH OF A DOLLAR



Source: Bloomberg

In short, these are not the ‘dot-coms’ of the late 1990s for which ‘eyeballs’ and ‘mouse-clicks’ were more important than sales and profits. Instead, most tech stocks today are viable companies offering products and services that many consumers feel they can no longer function without, a dependency we are really only aware of when the internet goes down or our phone dies in the middle of the day. At the same time, these technologies used by billions of people across the globe have been constantly collecting precious data on everything we do, and that data is now worth ... well ... a lot.

THE DATA-DRIVEN ECONOMY

Information has become a highly sought-after resource not too dissimilar to oil or other commodities. Data already powers almost everything these days (from inventory management systems, to our healthcare system, to the financial system that supports it all) and as more data is collected and analysed, the systems will become even better and more efficient.

In fact, the last decade hasn’t been the computer age; it’s been the *vanishing* computer age. As screens and artificially intelligent ‘smart

“The Economist recently published an article ‘Data is Giving Rise to a New Economy’ in which they referred to data as the fuel of the future, and that probably isn’t just hyperbole.”

systems’ have been implanted into almost everything we use and come into contact with, so the concept of a computer has become a little blurred. This gradual change nicely illustrates one unique principle of technological growth: we never really know what the world is going to look like until it happens. In the 1980s and 1990s, the conceived future was one of personal computers, just as we think in terms of smartphones and tablets today. Yet, if the past rhymes once again, our relationship with technology in just 10 to 20 years will likely be something very different than what we currently envision.

What is known is that investors have been greatly rewarded for their exposure to the technology sector over the last few years. Since March



The Byte-Sized Economy (cont.)

“Exponential technologies have a long way to go before their full impacts are realised, bringing tremendous potential for growth and investment.”

2009 when stocks bottomed after the financial crisis, the S&P 500 itself is up 262% while the technology sector is up a whopping 333% (as of 5/26/17). When the modern S&P 500 was created in 1957, industrial stocks made up 425 of the 500 spots, with 60 utility stocks and 15 railroad stocks rounding out the list. Now, more than 22% of the index is defined as ‘information technology,’ and it would be a tough task to find an area of the market where the proliferation of data and analysis hasn’t made a substantial impact. As a result, the tech-heavy Nasdaq Composite Index has finally eclipsed its dot-com bubble high after more than 15 years of largely moving sideways, and that may be just the beginning.

EVOLVING TECHNOLOGY

Naturally, this data-driven revolution is worrying to some, who readily recall the fallout from the dot-com bubble at the end of the 1990s that soured many investors on the concept of a ‘new economy.’ The market is always skeptical when someone says, “This time is different.” Yet, there have been monumental occasions in the past when it really has been different – the Industrial Revolution, the advent of the personal computer, and, now, the complete integration of electronic technology into our daily lives. We usually think of ‘technology’ as just gadgets and gizmos, but it’s simply the continuous progression of doing things better. Fire was technology. The wheel was technology. The steam engine and the assembly line were definitely technology. This is the next stage of that evolution, which is why it’s sort of a misnomer to label just one sector of the market ‘technology’ since it’s really describing the progression of humanity.

The most exciting part, though, is that we seem to be entering a new phase of this advancement, as so-called ‘exponential technologies’ are only now in the infancy of their life cycles (or at the bottom of their

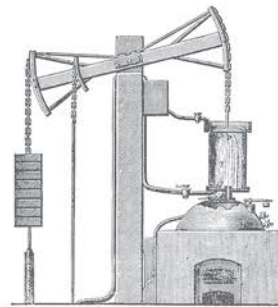
TECHNOLOGY OVER TIME



ABOUT 1 MILLION YEARS AGO
Changed the course of human evolution



AROUND 3500 B.C.
Created initially to serve as potter’s wheels



18TH CENTURY
Designed by James Watt



1913
Mass production reduced the time to build a car



TODAY
Exponential technologies continue the progression of humanity

Sources: history.com, smithsonianmag.com, popularmechanics.com



'S-curves' in tech parlance). We are somewhat familiar with innovations like robotics, virtual and augmented reality, 3-D printing, artificial intelligence and autonomous automobiles (however, at this point, they are mostly still in the 'Wright Brothers plane' stage of development). There is a long way to go before their full impacts are realized, which is fantastic news because this means there is tremendous potential for growth and investment. As a result, rapid progression in these and other related areas such as modern medicine, alternative energies and financial tech will, in our view, help drive this secular bull market to greater and greater heights over the next several years.

INTO THE GREAT BEYOND

Of course, there are always risks to progress. World governments are already struggling with how to regulate all this data collection and use, and cybersecurity will need to grow at the same rate as technology in order to keep pace with protecting that data. Privacy is also a concern in our modern society, and that promises to become even more of an issue as consumers push back on how their personal information is commoditised by corporations.

Because of these concerns, exponential technologies will be adopted at the speed the public and world governments will allow. Additionally, there is a threat of not having enough skilled workers to fill the employment needs of this new economy, as companies are already fighting a global war for talent. There needs to be a shift in the focus of education systems to teach the required skills of today and tomorrow, especially as automation continues to replace workers in an ever-growing number of fields. Otherwise, we run the risk of stagnating that expected growth.

However, it is very difficult to hold back progress completely, and we remain optimistic that much of the change to come will have a positive influence on our world. Technology has helped shrink the relative size of the planet, while fueling its economic development. It is unlikely that its impact is going to diminish as we progress forward. Consequently, we continue to believe it will help power this secular

bull market as new technological advances further disrupt the ways companies do business and how we interact with our world and each other. The world of science fiction will eventually become science fact, but the most amazing part is that we may not even realise it is happening. ■

KEY TAKEAWAYS:

- Like it or not, a data-driven society appears to be the direction our world, and world economy, is headed – and it's probably going to happen much sooner than most believe.
- Information has become a highly sought-after resource not too dissimilar to oil or other commodities.
- Investors have been greatly rewarded for their exposure to the technology sector over the last few years.
- We seem to be entering a new phase of this advancement, as so-called 'exponential technologies' are only now in the infancy of their life cycles, bringing tremendous potential for growth and investment.
- Rapid progression in areas such as modern medicine, alternative energies and financial tech will, in our view, help drive this secular bull market to greater and greater heights over the next several years.

Is the General Election Result Good or Bad for the UK Stock Market?

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

"Whenever you find yourself on the side of the majority, it is time to pause and reflect" Mark Twain

If a week is a long time in politics, then a couple of months is ample time to irrevocably change a political career. UK Prime Minister Theresa May's decision to hold an early June General Election was lauded by many as a wise step to boost her government's legitimacy – and majority. The resulting Hung Parliament and cobbled together deal with the Democratic Unionist Party to form a thin majority political bloc, is highly likely to be followed by her own quiet resignation before this new Parliament goes full term. History is unlikely to treat her decision as personally astute.

Financial markets, however, jump to a slightly different tune centred around expectations. The morning after the election day before saw the Pound the main financial metric whipping boy for the onset of new unanticipated political uncertainty. There was no huge surprise about this, given the precedent set by the aftermath of the Brexit referendum result, which resulted in the Pound ending 2016 scuttling around with currencies like the Argentine Peso and Turkish Lira, as the worst foreign exchange performer among a group of reasonably sized global economies. The General Election induced fall, however, was not only proportionately considerably smaller, but also – against global peers like the US Dollar or Swiss Franc – was surprisingly short-lived. Post-election currency uncertainties against almost all global currencies, except the resurgent Euro, are even now difficult to spot.

And this causes a problem for the UK stock market. The strongest theme of the last year in UK investing has been the greater value attributed to the non-Sterling earnings of the mining, pharmaceutical, energy and industrial shares that collectively make up the majority of the large cap UK stock market – hence the, at first glance strange, juxtaposition of Brexit referendum uncertainty and a rampant UK equity market. But no generalised Pound weakness brings the potential source of any equity market progress back towards the most domestically-centred financial, retail, building and construction sectors. And discussion of such sectors inevitably leads us back to the practical realities of Brexit.

Conventional market wisdom, at the time the election was called, was that the bigger majority the May government looked to be on the cusp of attaining, judging by early opinion polls, would allow a more expansive Brexit negotiation strategy, not beholden to any of her fellow Conservative MPs who wanted to 'get out of Europe at any cost'. A softer, more conciliatory Brexit which, via the use of transitional arrangements on tricky areas of trade legislation, would allow any material negative impacts on the UK economy to be largely avoided – just the type of economic reality which would provide comfort to the more domestically-centred sectors. Unsurprisingly, in the immediate aftermath of the General Election result, these areas of the UK market generally struggled.

The strongest theme of the last year in UK investing has been the greater value attributed to the non-Sterling earnings of the mining, pharmaceutical, energy and industrial shares that collectively make up the majority of the large cap UK stock market



ANNUALISED UK MARKET RETURN SINCE 1970

| | |
|---------------------|------------|
| CONSERVATIVE | 16% |
| LABOUR | 9% |
| COALITION | 9% |

Sources: HL, Bloomberg

Trends, however, are rarely straightforward in the equity markets, and in a move strangely reminiscent of a previous pro-Brexit campaign negotiation assertion of a ‘policy on cake is pro having it and pro eating it’, the weakened UK government position galvanised a nascent belief that there is little practical alternative but to compromise in Brexit negotiations – hence the aforementioned recovery in the value of the Pound – and a new focus again on the more domestic centred sectors.

The casual market observer is probably scratching their heads at the shifting sands of rationalisation, which all seem to lead towards higher stock market valuations and positive investment vibes. However, more seasoned observers will note the potential for disappointment in the still-fragile political arrangements, and the leap of faith that Brexit negotiations will be simple and straightforward. Conventional value criteria favour both the more domestic sectors and a higher value of the Pound, but a safer outcome is to expect an inevitable waxing and waning over both this Parliamentary term and Brexit negotiation epoch. The winning strategy for UK market investors is unlikely to be a simple pro-exporter or pro domestic sector strategy, but a realisation that the cross-currents of political and economic newsflow with individual company performances will become more important.

In short, the real value is knowing what you are investing in and why – and probably not being afraid to accept that the views of market participants will change and evolve.

The General Election has made adopting a more active approach to the UK a key stylistic call to make. ■

The winning strategy for UK market investors is unlikely to be a simple pro-exporter or pro domestic sector strategy, but a realisation that the cross-currents of political and economic newsflow with individual company performances will become more important

KEY TAKEAWAYS:

- A political gamble did not pay off and the General Election led to more uncertainty
- The Pound has, over the course of the last month, been less negatively impacted than most expected
- A compromise-centred Brexit policy favours more domestic sectors
- Adopting a more flexible and active approach towards the UK market appears sensible



Scott J. Brown, Ph.D., *Chief Economist, Equity Research*, outlines his expectations for economic growth.

Economic growth is an important factor in financial market performance and investors typically focus on near-term prospects while long-term trends are often overlooked.

In recent years, economists have increasingly come to accept the view that slower labour force growth will limit the trend in inflation-adjusted US gross domestic product (GDP). Financial markets may have yet to fully embrace this “new normal.”

TIGHTENING US JOB MARKET CONDITIONS

Monthly changes in nonfarm payrolls are subject to statistical uncertainty and difficulties in seasonal adjustment. This noise can be reduced, but not eliminated, by looking at a period of months. The payroll figures have shown a clear downtrend over the last few years, which likely reflects the tightening in job market conditions. Firms are simply running out of people to hire. The recent pace of job growth is still beyond a long-term sustainable rate, which is okay since there is some slack remaining in the job market. However, that slack is being reduced, leaving us closer to full employment. The unemployment rate fell to 4.3% in May, a 16-year low. The percentage of people involuntarily working part time has fallen. The unemployment rates for teenagers and young adults are trending lower.

Tight job market conditions are normally associated with faster wage growth. In recent months, average hourly earnings were trending at around 2.5% year-over-year, better than the 2.0% pace of a few years ago, but far short of the wage growth (3.5% or more) we would expect to see at such a low unemployment rate. Moderate wage growth likely reflects labour’s limited bargaining power. Union membership is a fraction of what it was in previous decades, and a higher concentration of large firms makes the job market less competitive.

Wage growth has been muted in 2017 on an inflation-adjusted basis. Gasoline prices are higher than last year. With more money going into gas tanks, households have less money to spend on other things. Rents have been rising faster than overall inflation. Healthcare costs are accounting for an increased share of household budgets. Consumer spending was weak in the first quarter of 2017. That’s not necessarily a problem – a soft Q1 17 following a strong Q4 16 is not surprising – but recent data suggests that the Q2 17 rebound is disappointing.

TRUMPONOMICS AND TAX REFORM

It’s no secret that U.S. politics have become more polarised. What’s unusual is that this division has become more clearly reflected in economic expectations. The University of Michigan’s May Survey of Consumers showed sharp differences by political affiliation, “with Republicans holding more favourable views on jobs and policies than Democrats.” According to the report, “The impact of this divide led most Republicans to expect a robust expansion and most Democrats to anticipate a recession.” That division may also be reflected in consumer spending. Retailers note some decrease in spending due to the crackdown on undocumented workers.

Business fixed investment rose sharply in the first quarter, largely reflecting the rise in business confidence. However, more than a third of that increase was in oil and natural gas drilling. Energy exploration contracted sharply from the end of 2014 to the middle of 2016. Oil and gas well drilling, which is capital intensive, rebounded some in the first quarter. However, beyond the energy sector, capital goods orders and shipments appear to have slowed to a more moderate pace into the second quarter.

Since the November election, financial market participants have been encouraged by the “Trump agenda” of reduced regulation, large-scale infrastructure spending and broad tax reform. However, even with one-party control of the White House and both chambers of Congress, this agenda is facing a significant uphill battle on Capitol Hill. Under broad tax reform, individual and corporate tax rates would be lowered, with lost revenue recovered partly through the elimination of most tax deductions. These deductions (also called “tax expenditures”) amount to \$1.5 trillion per year. However, nobody wants to give up their deductions and lobbyists will vigorously defend them. Congress may still lower tax rates later this year or in early 2018, but on a much smaller



scale than had been hoped for earlier.

A \$1 trillion deficit-financed infrastructure spending package is a nonstarter. Members of the House are not going to vote to boost the deficit. Private-sector funding of infrastructure has been proposed, but privatisation doesn't provide a boost to the overall economy and should be limited beyond airports and air-traffic control. By contrast, a rollback in regulations is easily achievable. Congress doesn't even need to change legislation. The executive branch can simply ignore the regulatory laws on the books. However, it's unclear how much restraint regulation has imposed on the overall economy.

Even if the Trump agenda were enacted in full, the economy would remain subject to labour market constraints. Indeed, consensus forecasts for GDP growth were raised only marginally following the election and have softened a bit more recently.

SLOWER GROWTH TRENDS

Slower-trending U.S. economic growth creates a number of intermediate-term concerns, and countries around the world face similar challenges. One issue is how to improve the standard of living. Another is how to fund the retirements and healthcare of aging populations. Entitlement spending (Social Security and Medicare) accounts for an increasing portion of federal government spending. Eliminating all nondefense discretionary spending, an extremely unlikely prospect, would still leave us with a budget deficit.

Efforts to boost growth beyond the 1.5 - 2.0% sustainable trend should be directed to two areas: adding to labour force growth and boosting productivity growth. The Labour Department projects that potential labour force growth will average about 0.5% per year over the next ten years, with immigration accounting for about 40% of that. Slower population growth could be offset by increased immigration. Instead, both legal and illegal immigration have slowed this year. Productivity-enhancing capital expenditures rose in the first quarter, but it remains to be seen whether such a strong pace will continue. Longer term, advances in technology, principally robotics and artificial intelligence, should help offset slower labour force growth. However, it's difficult to say by how much.

For the most part, we are only talking about a slower trend rate of economic growth, not a recession. However, for any given pace of GDP growth, some sectors will grow faster than others. As trend growth slows, some sectors will be in contraction. *Historically, the strength of the U.S. economy has been its ability to evolve and adapt to changing circumstances.* One hundred and fifty years ago, most of the economy was in agriculture. Sixty years ago, one out of every three jobs was in manufacturing. The future will look different to us in ways we cannot see now. However, it seems clear that the U.S. will need a more adaptive, better-educated workforce. ■

KEY TAKEAWAYS:

- In recent years, economists have increasingly come to accept the view that slower US labour force growth will limit the trend in inflation-adjusted gross domestic product (GDP). Financial markets may have yet to fully embrace this “new normal.”
- Since the November election, financial market participants have been encouraged by the “Trump agenda.” However, this agenda is facing a significant uphill battle on Capitol Hill.
- Historically, the strength of the U.S. economy has been its ability to evolve and adapt to changing circumstances. The future will look different to us in ways we cannot see now. However, it seems clear that the U.S. will need a more adaptive, better-educated workforce.

Will Macron and Merkel Save the European Union?

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

"Don't build a glass house if you're worried about saving money on heating" Philip Johnson

Europhiles will tell you that the two most important continuing members of the European Union not only need the help of each other, but are on the cusp of forging a new entente cordiale, which will drive the European Union back to the high points of hope and political cohesion not seen for almost a generation. In this thinking the mercantilist Germans – with Angela Merkel looking a clear favourite to extend her decade plus reign as German Chancellor after September's elections – appear to be starting to understand that they cannot rely on the export markets of the United States and Asia forever, and want to re-engage more deeply with their fellow European nations. Meanwhile, the regionally highly influential French, with the election of Emmanuel Macron as their President, appear ready to acknowledge some element of economic change has to occur – a realisation which would cascade through the region and inspire other European Union nations to consider economic reforms of their own.

Such thinking is long overdue as the European Union has underperformed the United States on most conventional economic and financial market criteria for the last decade. And even though the worst fears coming into 2017 – the election of populist governments and further members following the lead of the UK and indicating their preference to exit – have not occurred, a feeling towards change of 'now or never' is beginning to build. Otherwise, the next cycle of political elections may not have such mainstream reactions.

Aside from political expediency, what are the main rationales for believing change is just about to occur? For Germany – the de facto paymasters of Europe – the rationale is partially practical economics, partially political legacy building and, finally, partially because of their inherently pan-European feelings.

The practical economic feelings that Germany has towards the rest of Europe has been largely laid out above: lower regional growth rates suppress demand for German exports, forcing the latter to seek alternative markets further afield – a risky strategy if the euro ever

The European Union has underperformed the United States on most conventional economic and financial market criteria for the last decade

rises sharply in value or if defections from the European Union get a competitiveness boost from sharply depreciating currencies against a German dominated continuing euro.

Mindful of either of these two options, Angela Merkel is looking to build her political legacy in the knowledge that her Chancellorship is unlikely to run for too many more years – and what better way to go than having put Europe back onto the straight and narrow. That Germany and Mrs Merkel are committed to Europe is shown by the pragmatic way they have adopted negative interest rates, quantitative easing, immigration and agreed support and payments for reform to troubled southern European nations. The trouble is, the prolonged debates and extensive compliance guidelines have not engaged the wider pan-European electorate.

And this is where Emmanuel Macron – the new President of France – can offer a helping hand. France's role in Europe has always been as a counterweight to progressive German economic strength, and a France that accepts that the European Union needs to become more competitive and dynamic could inspire the rest of the region to undertake their own domestic, political led reforms. However, given that initiatives such as new labour legislation, tax reform and changes to training/education take time to produce any benefits, the enhanced

A France that accepts that the European Union needs to become more competitive and dynamic could inspire the rest of the region to undertake their own domestic, political led reforms

winning the September General Election in Germany, but then bringing a nervous domestic populace with her on a broader pan-European journey involving still difficult decisions with countries like Italy and Greece. And for both, it requires striking the optimal tone over Brexit to ensure no material economic impact on the still economically recovering European Union.

The last couple of months have shown – via rising local equity markets and a higher euro – faith in the potential of this relationship. The next six months are going to have to show further progress to retain investor faith through into 2018. It is not hyperbole to suggest the future of the European Union depends largely on how these two leaders progress. ■

use of tax and spending ‘fiscal stabilisers’ makes good sense. And the main opposition to such stabilisers? The German desire for prudent European Union financing.

Put together, the Merkel-Macron combination could start to put into place the shifting of the European Union squarely into the economic 21st Century, with all the resulting benefits to regional equity market valuations that would occur. However, such a combination requires movement from both sides. For Macron, it means using his newly acquired Parliamentary majority to start the process of pushing through new labour market and related legislation, despite the inevitable opposition domestically. For Merkel, it means not only

KEY TAKEAWAYS:

- The European Union has endured a very difficult last 10 years economically and politically
- Both Germany and France individually and collectively have incentives to make the European Union work
- The market expects further progress with the next 6 months critical for holding investor faith into 2018

SUPPLY SIDE ACTIONS IN RESPONSE TO OECD RECOMMENDATIONS (2015-16)

| | Reform recommendations | Reforms undertaken |
|------------------------|------------------------|--------------------|
| Labour market policies | 40 | 10 |
| Labour tax policies | 35 | 12 |
| Tax structure | 34 | 3 |
| Competition | 61 | 22 |
| Human capital | 67 | 20 |
| R&D | 21 | 5 |

Source: OECD



Q&A: The Future of Fuel

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research*, shares his thoughts on how the connection between technology and oil is shaping what's to come in the energy sector.

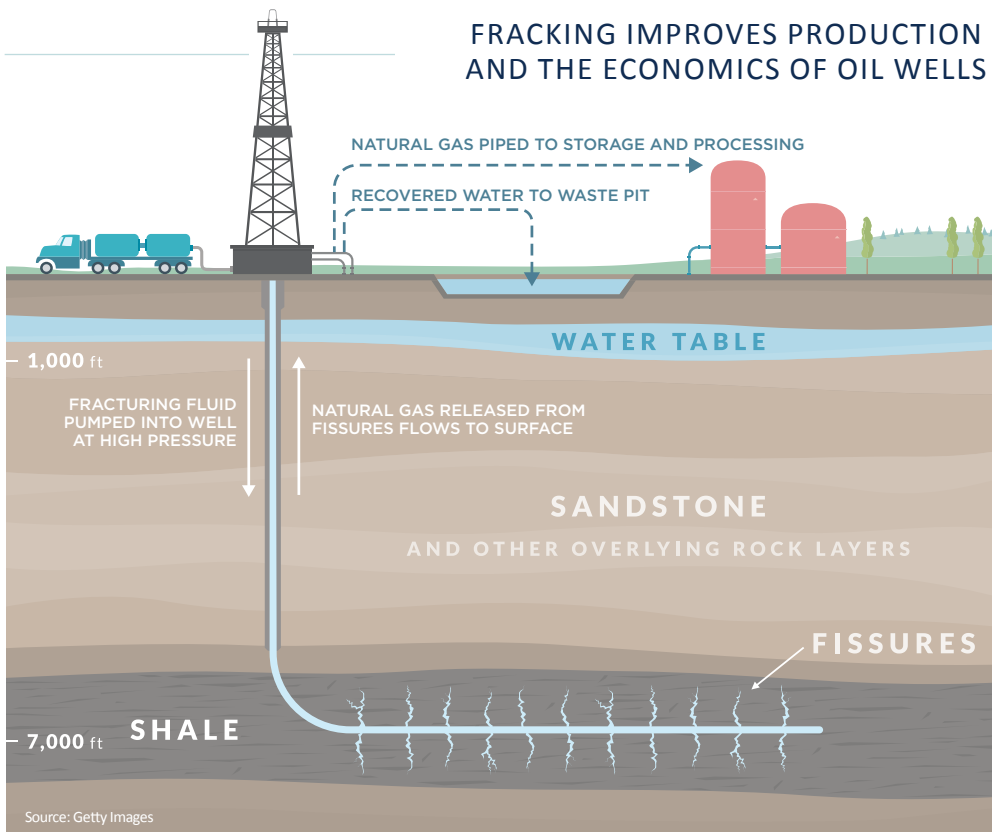
Q. HOW HAS TECHNOLOGY CHANGED THE OIL INDUSTRY OVER THE PAST DECADE?

A. As global oil supply has grown over the past century, currently reaching production levels of 100 million barrels per day, new technology has enabled production to take place in geographic locations that had not previously been accessible or economical. Significant developments include enhanced oil recovery and deep-water drilling.

Over the past decade, the most impactful new technology for extracting oil (and natural gas) has been hydraulic fracturing ("fracking") alongside horizontal drilling. This, more than

anything, has enabled U.S. oil production to reverse three decades of declines since 2010. In the Bakken (North Dakota), Eagle Ford (South Texas) and Permian Basin (West Texas and New Mexico), fracking is a critical tool for the industry in improving the productivity, and thus the economics, of oil wells. Fracking is also being employed to a lesser extent in parts of Canada, and is in the early stages of implementation overseas, in places like China and Argentina.

As technology is helping make the oil supply more plentiful and cheaper, it is also contributing to slowing the growth rate of demand for oil. Strictly speaking, this isn't an oil industry issue, but more a



GLOBAL OIL SUPPLY

100 MILLION
BARRELS PER DAY IN
PRODUCTION



U.S. OIL PRODUCTION

FRACKING
HAS HELPED
REVERSE
30 YEARS OF
DECLINES
SINCE 2010.





AIRCRAFT WINGLETS

Winglets reduce drag by altering the flow of the vortices created by the wing. They also increase the area of the wing, which creates lift.



| | |
|----------------|---|
| 4% | SAVINGS IN FUEL BURNED |
| 130,000 | GALLONS OF FUEL SAVED PER AIRCRAFT PER YEAR |
| 4% | CO2 EMISSIONS REDUCED |

Source: Boeing

matter of transportation engineering. It is hardly a secret that modern car engines are more efficient than those from 10 or 20 years ago, enabling the same distance to be traveled using less fuel (all else being equal). An example of a technology that’s not as well-known would be “winglets” on aircraft. Next time you fly, check out the tips of the wings. Those add-ons make planes more aerodynamic, shaving as much as 5% off fuel consumption.

Electric vehicles (“EV”) are probably the highest-profile example of new technology that can reduce oil demand, even though they will not become needle-moving for oil demand for a long time. Despite some of the EV-related hype in the media, EV adoption has actually been running more slowly than the industry had originally expected. We project that all EVs sold globally, on a cumulative basis through 2020, will displace only about 0.25% of global oil demand in that year. The earliest that EVs could single-handedly prevent global oil demand from growing would be after 2025. This is also the timeframe that self-driving/autonomous vehicles will come on the market.

Q. THE PRICE OF OIL FELL AFTER OPEC ANNOUNCED A RECENT CUT IN PRODUCTION. HAS THE CARTEL LOST ITS FORMER INFLUENCE?

A. Even without the recent decision by OPEC and Russia to extend their production curtailments, it is important to point out that global oil inventories were already heading substantially lower in 2017. The extension, all else being equal, should provide a 1.1 million barrel per day average benefit (versus our pre-extension oil model) from Q3 2017 to Q1 2018, and this is a big deal. There is nothing in the OPEC decision, as telegraphed as it had been, that should have logically resulted in a 5% oil sell-off that day. All we can say is that markets are not rational 100% of the time, and, ultimately, fundamentals are what matter. The fundamental picture for oil inventories is that they are on track to drop below normalized levels later this year. This is inherently bullish for oil prices, which is why we expect prices to reach cyclical highs over the next six to nine months.

Growth of non-OPEC oil supply has certainly made OPEC’s position in the oil market less central than it had been for much of the past



Q&A: The Future of Fuel (cont.)

OIL INVENTORIES

OPEC AND RUSSIA

PRODUCTION CURTAILMENTS EXTENDED



1.1 MILLION BARRELS PER DAY

AVERAGE BENEFIT FROM Q3 2017 TO Q1 2018

half-century. However, Saudi Arabia individually remains an important swing producer. Some of the smaller OPEC members have shown very little willingness to comply with their pledged production cuts, but Saudi Arabia has actually cut more than it was supposed to. The fact that they continue to play a cooperative role in helping rebalance the global oil market is bullish.

Q. HAS SAUDI ARABIA ATTEMPTED TO DIVERSIFY ITS ECONOMY IN THE WAKE OF LOW OIL PRICES?

A. The question of what is motivating the Saudi Arabian production discipline is a matter of speculation: we can see what's happening, but not why. One popular theory these days is the notion that the state is deliberately propping up oil prices in order to improve market conditions for the long-anticipated Initial Public Offering (IPO) of its national oil company, Saudi Aramco. That would suggest that the state will revert to a less cooperative stance if and when the IPO occurs, potentially sometime in 2018. Other variables can also be at work, however. For example, the Saudi budget – particularly given the ongoing war in Yemen – clearly cannot sustain sub-\$50 oil forever. Those \$110 billion arms deals don't pay for themselves! Additionally, the royal family is well aware that permanent fiscal austerity is hardly a recipe for maintaining social cohesion (i.e., keeping themselves on the throne).

Saudi and the smaller Persian Gulf states have an advantage in that they have relatively small populations and, therefore, high oil revenue per capita. The same goes for Norway and Canada. Also, Saudi has a sizable "rainy day fund" in the form of its currency

reserves. The oil down cycle of the past three years has been much more damaging for the lower-income oil exporters, such as Venezuela and Iran. These countries, and to a lesser extent Russia, have struggled economically amid the austerity that the reduced export earnings have caused. On the other hand, let's not overlook the fact that cheap oil is positive for most of the world's emerging markets, which tend to be oil importers, with China and India being the most obvious examples. ■

KEY TAKEAWAYS:

- Over the past decade, the most impactful new technology for extracting oil (and natural gas) has been hydraulic fracturing ("fracking") alongside horizontal drilling. This, more than anything, has enabled U.S. oil production to reverse three decades of declines since 2010.
- As technology is helping make the oil supply more plentiful and cheaper, it is also contributing to slowing the growth rate of demand for oil.
- The fundamental picture for oil inventories is that they are on track to drop below normalised levels later this year. This is inherently bullish for oil prices, which is why we expect prices to reach cyclical highs over the next six to nine months.
- Let's not overlook the fact that cheap oil is positive for most of the world's emerging markets, which tend to be oil importers, with China and India being the most obvious examples.

All expressions of opinion reflect the judgment of the Equity Research Department of Raymond James & Associates, Inc. and are subject to change. There is no assurance any estimates will be met. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

DISCLOSURE

Issued by Raymond James Investment Services Limited (Raymond James). The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance is not a reliable indicator of future results. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. The taxation associated with a security depends on the individual's personal circumstances and may be subject to change.

The information contained in this document is for general consideration only and any opinion or forecast constitutes our judgment as at the date of issue and is subject to change without notice. You should not take, or refrain from taking, action based on its content and no part of this document should be relied upon or construed as any form of advice or personal recommendation. The research and analysis in this document have been procured, and may have been acted upon, by Raymond James and connected companies for their own purposes, and the results are being made available to you on this understanding. Neither Raymond James nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such research and analysis. If you are unsure or need clarity upon any of the information covered in this document please contact your wealth manager.

APPROVED FOR CLIENT USE

RAYMOND JAMES®

Head Office Broadwalk House 5 Appold Street London EC2A 2AG
www.RaymondJames.uk.com