

INVESTMENT STRATEGY QUARTERLY

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Letter from the Chief Investment Officer

Sailing on Strange Seas

Investors had become used to smooth sailing beguiled by, in particular, the US economy remaining resilient, strength across developed world equity markets, and volatility remaining (mostly) subdued. But as we extend our voyage into unknown seas, we will need to maintain a steady hand on the tiller, recalling the old sailing motto that “*The good seaman weathers the storm he cannot avoid, and avoids the storm he cannot weather.*” So come sail away with me as we use eclectic sailing references to outline our views for the economy and financial markets and chart their course for the remainder of this year and 2024.

While Federal Reserve (Fed) Chairman Mr Jerome Powell is not officially a sailor, he is the proverbial captain of the US economy as the Fed’s actions have a major impact on its direction. Given the unprecedented way the world’s largest economy has reacted to COVID, the central bank’s traditional GPS readings have been less reliable. Ironically, Mr Powell sounded like an old salt himself when he recently said the Fed is “navigating by the stars under cloudy skies.” To his point, US household spending has been robust, especially during the summer as consumers spent like drunken sailors on travel and leisure. But just as you don’t sail a boat backwards, you can’t determine the direction of the economy by looking behind you. And from our vantage point, a consumer spending fog is rolling in as job growth slows (turning negative in 2024), excess savings disappear, and borrowing becomes more costly. While US government spending on infrastructure has helped buoy that economy, it will likely not be enough to offset the decline in consumer spending. As a result, we estimate the US economy will experience a mild recession in the first part of 2024 before rebounding in the second half. As a result, 2024 GDP will notch a small 0.4% growth rate—so not a disaster.

Given this economic outlook, we expect that the Fed is nearing the end of its tightening cycle, with possibly one last interest rate hike this year. Its goal of submerging inflationary pressures is on course and will gain momentum reinforced by lower housing costs as we progress through 2024. The headwinds associated with challenging growth, amid decelerating inflation should allow the Fed to begin cutting interest rates around mid-year next year. What could cause a broken mast to shipwreck the economy? The Fed crying out like the famous commander David Farragut to “Damn the torpedoes! Full speed ahead!” If the Fed is overzealous in lifting interest rates higher than we forecast or if they do not proactively cut rates to put a breeze into the sails when needed, it that could cause a deeper recession. Oil prices surging sustainably above \$100/barrel and dampening consumer confidence and spending power is also a

risk on our radar. Fortunately, neither of these more severe scenarios are on our expected course.

For the sovereign bond market, the famed merchant and occasional sea traveller Marco Polo comes to mind. Legend has it that, while traveling to China, he got separated from his family. When they called for him as ‘Marco!’, he reportedly responded ‘Polo!’—just like in the pool-based game. Like his family (and the closed-eyed player in the game), we keep searching and ‘calling out’ for lower interest rates. But, they remain elusive—and at elevated levels. However, we’re still sailing steadily toward a prediction that the 10-year Treasury bond yield will hit 3.5% over the next 12 months. Persistent recessionary concerns, falling inflation, and reduced speculative selling of the bond market should support interest rates moving lower. We’re focused on the pool of Treasuries bonds, as well as high quality corporate bonds and municipal fixed income alternatives. Swimming in both the short end (shorter maturities) and deep end (longer maturities) of the sea remains of value. But over the next six to nine months, investors should transition to the deeper part of the pool. The breezes that we remain alert to include higher risk, high yield bonds that do not hold a favourable risk/reward profile at current levels.

For the equity market, we turn to a hero of our youth, Popeye the Sailor. For those too young to remember, Popeye appeared weak ... until transformed by his secret strengthener: a can of spinach. Typically, market performance is driven by the ‘spinach’ of earnings growth, but, paradoxically, the stock markets’ returns this year have been driven by price/multiple expansion, more a measure of sentiment, not underlying fundamentals. In fact, forecast 2023 earnings growth is in the doldrums. To strengthen the current market rally, companies will have to ‘eat their canned spinach’—that is, grow earnings. But a good can of earnings growth might be hard to find. Next year’s challenging economy will make top line sales growth difficult and will force companies to manage their expenses to

maintain their margins. From the crow's nest we do not expect corporate earnings to slip precipitously, but rather tread water in 2024, supporting our more cautious 12-month outlook for the US S&P 500 of 4,650. A healthy ration of spinach will likely not be served until 2025.

One of Popeye's important characteristics was his loyalty, especially to his wife, Olive Oyl, and his adopted son, Swee'Pea. Similarly, we remain committed to our equity and international preferences from the previous quarter. Within the US equity market, we favour the Technology, Health Care, Financials and Energy sectors. These sectors continue to offer the best visibility into earnings even if we have a mild recession next year. While slowing economic activity will likely act as an anchor for small-capitalisation stocks in the near term, small caps should be ready to set sail at some point in the first half of next year as economic activity bottoms and then subsequently improves.

Internationally, we still prefer the US because of the macro backdrop—a more resilient and dynamic US economy should limit the downside to economic growth and lead to a faster recovery. International investor enthusiasm may be supported by the dollar's relative resilience. In addition, US companies tend to be more technologically advanced and have greater profitability/efficiency which should help navigation in a choppy environment. However, there are several opportunities on the global horizon that are still worth exploring. For centuries, finding the shortest route to India was every sailor's dream. Portuguese explorer Vasco de Gama, the first European to sail around the Cape of Good Hope to India, realised that dream, establishing valuable trade relations in so doing. Now, instead of spices, India offers opportunities in technology and 'friend-shoring' especially with the shift away from China and should benefit from favourable demographic trends too. Select areas of Latin America (e.g., Mexico and Brazil) should benefit from

elevated commodity prices and their respective central banks easing monetary policy.

When it comes to investing, it takes skill to navigate the tension between going faster versus making a wrong decision running aground. In uncertain times, don't try to learn the ropes on your own—we all need a crew! Your financial advisor can provide the compass to guide you through investing challenges. Finally, we want to remember one of the most fun sailors of all time, Jimmy Buffet. Here's a "Parrothead" wish from us to you: may you reach your financial goals early so you can enjoy "It's 5 O'Clock Somewhere," eat a "Cheeseburger in Paradise," and spend vacations in "Margaritaville"!

Wishing you fair winds and following seas,



Lawrence V. Adam, III, CFA, CIMA®, CFP®
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The Corset, The Contraction And The Financial Markets

Prof Jeremy Batstone-Carr, *European Strategist*, Raymond James

It was Peter Lynch, former manager of Fidelity's flagship Magellan Fund and writer of the book "One Up On Wall Street" who once said "If you spend thirteen minutes a year on economics, you've wasted ten minutes!" It's debatable as to whether that was ever entirely true, although it certainly served his purpose when managing the fund through the buoyant period for stock markets during the 1980s and 1990s, but it certainly is not true now. Twenty-five years ago, in 1998 and very much overshadowed in the general consciousness by a simultaneous Russian default on its sovereign debt, a giant hedge fund going by the innocuously named Long Term Capital Management collapsed, triggering a bailout by the US government to prevent a possible financial market melt-down. Shortly thereafter the Bank of Japan cut interest rates to zero and a year or two later embarked upon the then unconventional monetary policy now known as quantitative easing. The world's largest central banks adopted the programme during the Great Financial Crisis, heading off the threat of an economic and

financial market collapse but in so doing took hitherto little known monetary policy into territory only previously debated in economic textbooks. The policy galvanised financial markets and asset prices soared throughout this century's second decade. Then COVID struck, a period during which governments and central banks worked in lockstep to mitigate the economic impact, giving rise, once the pandemic subsided, to a late-stage economic cycle like no other. Inflation, long dormant, resurfaced requiring a forceful monetary policy response. The question for investors now is, where do we go from here?

IS INFLATION REVIVING?

Policies adopted by governments and central banks to mitigate the economic consequences of pandemic-inspired lockdowns and their lasting impact on consumer spending are discussed elsewhere in this publication. However, what is also known is that the liquidity boost that proved so supportive to financial assets over the period generated a hyperbolic expansion of the money supply, an event a monetarist would have no difficulty in recognising as the precursor to an inflationary episode. Initially the world's most important central banks stood back from

raising interest rates in response to the inflation tsunami, describing rising price pressures as “transient”. But their resolve broke in late 2021, the Bank of England being the first to “break cover” and begin what we all now know to be the most aggressive concerted programme of interest rate hikes since the 1970s.

Monetary policy works with a lag, so the impact of higher interest rates on inflation only really began to be felt over the latter months of last year, but progressively thereafter. By June global headline inflation had almost halved from the near 8% peak levels of September 2022 to just 4.4% driven by falls across both developed and emerging economies and principally reflecting a fall in energy prices. Underlying inflation, excluding food and energy prices, proved much harder to shift, moderating from a peak 6% to just under 5% over the same period.

Simultaneously, Western developed economy central banks have been steadily reversing the quantitative easing of the past, running down replete balance sheets by selling bonds back to investors. The combination of liquidity removal through this quantitative tightening and higher interest rates is having a direct impact on developed economy activity which, having been subdued for months, is now showing increasing signs of slipping into contraction in the UK and eurozone and a sharper slowdown in the US. Few developments in economics are more certain to trigger an economic contraction than a decline in bank lending to the economy but, as a direct consequence of monetary policy decisions, that is what is happening.

And this will come as no surprise to central bankers either. Indeed, ECB President Mme Christine Lagarde even referenced the weakening in credit dynamics in her mid-September post-meeting press conference. The justification for raising interest rates by 5% or more in the UK and US, and to 4% in the eurozone may be all about suppressing inflation and heading off its nascent revival, but there is more to it than that. For all the talk of price pressures rekindling, data throughout the autumn should confirm that year-on-year inflation is trending lower, in large part a function of the basis effect as last year’s high levels drop out of the annualised calculation. As inflation falls, so real interest rates rise (interest rates less CPI inflation) and keep on rising. In the US real rates are as high now as they were in 2007 and they’re about to turn positive in the UK and Euro Area too. Thus, by holding monetary policy steady, as seems likely, central bankers have applied an ever-tightening corset around the real economy in a deliberate attempt to suppress demand.

In the financial markets attention has focused on rising sovereign bond yields. To some extent this partly reflects fears of a possible US government shutdown as the new fiscal year begins and in other part, increased bond issuance in response to rising debt levels. However, markets are spooked by inflation’s possible revival, most notably (but not exclusively) as the rising crude oil price results in higher fuel prices. As economic activity subsides and inflationary pressures diminish, sovereign bond prices should rise and yields fall back.

But what might happen if inflation really does prove irrepressible? What impact might this have on asset allocation and portfolio management? Over the past decade zero interest rates and fast-growing central bank balance sheets ensured that the stock market was the only game in town. Nothing, be it bonds, cash, commodities or real estate came anywhere near delivering similar returns. There really was no alternative. One pandemic and a series of rate hikes later the investing landscape has adjusted and sovereign bonds appear cheap relative to stocks. The typical justification for holding bonds in a diversified portfolio is to reduce risk by lowering volatility, while only marginally impacting on total returns. But government bonds might not deliver if inflationary pressures remain “sticky”. Other assets, such as corporate bonds, index-linked securities and commodities might have a lower Sharpe ratio (a formula that expresses investment returns compared to risk) but are far from risk-free and historically only deliver excess returns fleetingly. Thus, by a process of elimination, the temptation might be to add exposure to the stock market irrespective of the near-term outlook for the economy, especially so if the rollout of artificial intelligence truly does deliver a productivity miracle in the years ahead.

KEY TAKEAWAYS:

- The 25th anniversary of the collapse of Long Term Capital Management ushered in a transformative period of unconventional monetary policy.
- Pandemic-era policies induced a sharp increase in the money supply, thus provoking inflation’s revival.
- Central banks have raised interest rates in response, but inflation is not yet vanquished, reflected in financial asset pricing.
- If price pressures diminish, as economic activity subsides, bond yields should fall. But if inflation remains “sticky” the stock market may yet prove the best hedge.



Redefining Resilience: The Unstoppable Consumer

Eugenio J. Alemán, Ph.D., *Chief Economist, Raymond James*

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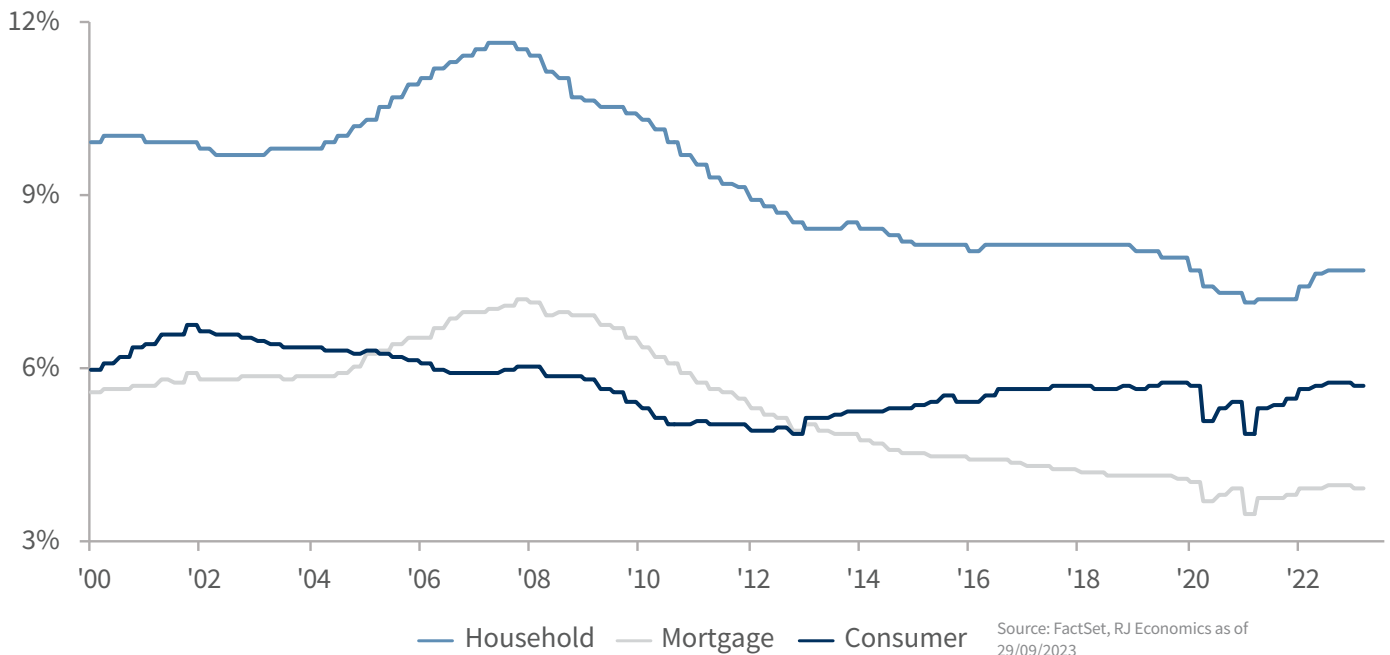
High interest rates and elevated rates of inflation seem to be good textbook examples of factors that would negatively impact consumer spending, as higher borrowing costs and more expensive goods reduce consumers' purchasing power. However, fiscal policy in the form of direct money transfers from the government meant to cushion any potential difficulties for households due to the pandemic and, in the UK, the impact of sharply rising energy prices in late 2022, has supported consumers' ability to spend over the past three years. In the United States households have added almost \$3 trillion in debt since the pandemic began while in the UK the combination of still strong labour demand, fast wage growth and government support packages have all served to cushion the worst impact of falling disposable incomes. Although falling inflation on both sides of the Atlantic Ocean is supporting real incomes, the phasing out of earlier support packages implies strongly that in real (inflation adjusted) terms UK household disposable incomes will not return to pre-pandemic levels until early 2025. In both locations, many households fortunate enough to save during the pandemic period are seeing this buffer diminish and although interest rates are likely at, or close to their peak levels the lagged impact of

earlier policy tightening, coupled with an unknowable period during which monetary policy will be unadjusted, foreshadows a migration away from a cost of living to a cost of borrowing headwind.

FADING FORTUNES

Before diving into the consumer in more detail, it is important to analyse how the economic landscape has changed during the last three years, and most importantly, how different "return to normal" economic conditions will be. The COVID pandemic fundamentally changed economies around the world and has arguably impacted the consumer the most. After periods of lockdowns, supply-chain disruptions that reduced both the supply and consumption of goods, an overall inability to consumer services, and yet substantial quantities of fiscal policy support, disposable incomes were maintained to the extent that, in the US, disposable incomes peak at almost \$22 trillion in March 2021. What happened after the US, UK and indeed global economies eventually reopened can only be described as a surge in pent-up "revenge spending". However, August data pertaining to developed Western economies excess savings accumulated during the pandemic points to heavy usage to levels close to severe depletion. Nevertheless, if employment remains as strong as it is today, it will be enough to support consumer demand, as well as economic growth.

The Cost of Debt Service Has Declined Since the Great Recession



DEBT MATTERS, BUT EMPLOYMENT MATTERS MORE

While wages and salaries, as well as excess savings due to fiscal transfers, took care of many expenses during the past two years in support of this “revenge spending”, household debt levels have increased too, to \$17 trillion in the United States according to the Quarterly Report on Household Debt and Credit. Despite optically high levels of indebtedness, those levels are lower as a percentage of GDP than was the case during the Great Financial Crisis period of 2008/09. Moreover, the cost of servicing household debt – made up largely of fixed low interest mortgages taken out before, during or shortly after the pandemic – is at one of its lowest points in recorded history. This gives households the ability, on paper at least, to consume more at the same level of income, albeit that inflation has resulted in a widespread affordability crisis for many.

Although interest rates have risen, the situation as it pertains to mortgages is rather different in the US to that prevailing in the UK. In the former, more than 82% of households have a mortgage with a rate below 5%. In The UK, despite the decision to keep the base rate of interest on hold at 5.25%, the Bank of England has convinced financial markets that interest rates will remain at prevailing levels for some time. As market interest rate expectations determine fixed mortgage rates, the recent surprise decision does not alter the view that UK mortgage rates will likely remain around current levels until the middle of next year. On the other hand, credit card debt is dangerous to consumers because it

carries the highest interest rates, on average well over 20%. Therefore, this is something that could become a headwind for consumer spending in the future if delinquency rates on credit cards were to increase. Currently delinquency rates are fairly low, averaging at around pre-pandemic levels so this is not an issue yet, but it could become one in the future.

THE UK LABOUR MARKET IS COOLING, BUT ONLY SLOWLY

The latest data supplied by the UK’s Office for National Statistics (ONS) covers July and August and reveals that conditions have continued to ease, but only very slowly. The three-month change in employment eased from -66,000 in June to -207,000 in July while the number of job vacancies also slipped, the three-month average dropping from 1.017 million in July to 0.989 million in August, first-time vacancies have slipped below 1.0 million since July 2021. The easing in demand for labour was partially offset by a 63,000 increase in the level of inactivity over the three months to July (and note that the UK labour force is still 0.3% below its pre-pandemic level and long-term sickness continues to keep many people out of the labour market), but the UK’s unemployment rate still increased slightly, from 4.2% to 4.3%. As a reminder, it stood at just 3.5% in August last year.

What remains a concern for the Bank’s rate-setting Monetary Policy Committee, split 5-4 in favour of an unchanged base rate, is that the slight cooling in labour market conditions has yet to feed through to lower wage claims. While the monthly

“Today, while we are expecting employment to weaken going forward and consumption to slow, the US economy has continued to get support from several fiscal bills, such as the CHIPS Act, the Inflation Reduction Act (IRA), and the Infrastructure Bill, which have all contributed to keeping investment from responding more severely to higher interest rates.”

rate of earnings growth did slip from 2.2% in June to -0.9% in July this was largely the consequence of June’s one-off bonus for NHS workers not being repeated in July. The headline three-month annualised rate of wage growth actually increased from 8.4% to 8.5% within which the Bank’s preferred measure, private sector wage growth, remained elevated at 8.1% in July, still far above its own 6.9% predicted level for September. All this implies that, while conditions are easing, the UK labour market remains tight and still supportive to economic activity more generally.

IT IS ALL ABOUT JOBS IN THE US TOO

Economic growth in the US is driven primarily by consumer spending, just as it is in the UK (accounting for around 70% of GDP). What allows consumers to spend is their disposable income, which under normal circumstances (i.e. no fiscal transfers like those occurring during the pandemic) is directly tied to the labour market. When people are employed, they earn wages and salaries, which contribute to overall income. Employment and personal consumption expenditures have a correlation higher than 90% in both the US and UK economies, suggesting that if employment conditions remain broadly stable then consumption patterns should be stable too. Furthermore, as long as the labour market remains resilient, there are alternatives (obtaining a second or part-time job, gig economy etc) for individuals to complement their income and keep consumption going.

As the impact of higher for longer interest rates slows developed economies into what are still thought likely to be very shallow contractions, our expectation is that the labour market will continue to soften and employment conditions deteriorate, but not markedly so. In the United States we estimate the number of job losses to be around 500,000, the smallest number of jobs lost during a recession, well below the average 3.5 million jobs lost and nowhere near the 20

Economic growth in both the US and UK is driven primarily by consumer spending which accounts for c.70% of GDP.

million US jobs lost during the Great Financial Crisis or Great Recession.

The lifeline of the consumer is income and as explained above, whilst we expect employment to weaken in the short-term, consumers are likely to be able to continue to consume if the labour market slowdown is comparatively mild and inflationary pressures continue to subside, as we believe they will. Conversely, higher interest rates are making it increasingly more expensive to borrow, effectively limiting households’ ability to borrow in support of increased consumption. The same is true for businesses too. If the business environment deteriorates and employment conditions soften, as expected, many households will have trouble paying back debts and this will put pressure on economic activity. The good news is that typically, in a recession, automatic stabilisers (unemployment benefits, social security programmes etc) will soften the burden for those who lose their jobs. This is why, during economic slowdowns, the consumer impact is typically moderate.

The bottom line: The consumer is the backbone of all major developed Western economies and persistent resilience has contributed in no small measure to economic activity as economies have exited the COVID-19 pandemic-induced recession. Today, while we are expecting employment to weaken going forward and the pace of consumption to slow,

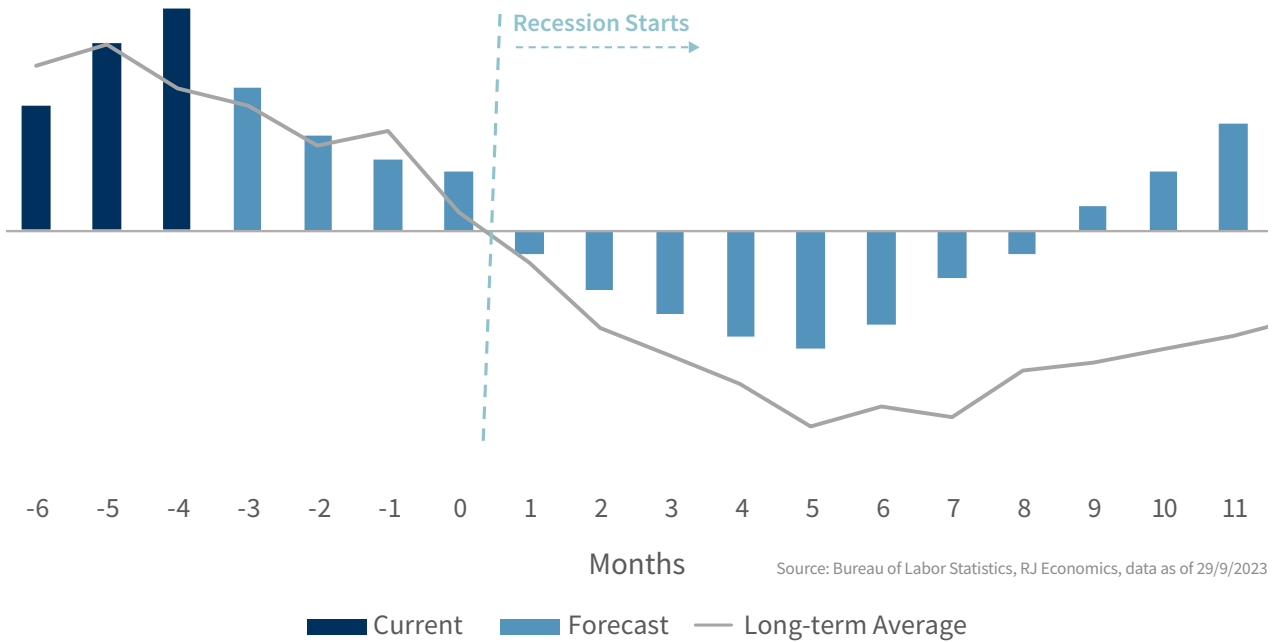


EFFECT OF STUDENT LOANS ON GROSS DOMESTIC PRODUCT FORECAST

	2023	2024
Current Forecast	2.1%	0.4%
\$200/month	2.0%	0.2%
\$400/month	2.0%	0.0%

Source: National Student Loan Data System (NSLDS), RJ Economics, data as of 30/6/2023

Job Losses Should be Limited (in thousands)



the support provided by several fiscal bills in the United States (CHIPS Act, Inflation Reduction Act, Infrastructure Bill) should cushion the impact of higher rates on investment and limit the extent of any downturn.

KEY TAKEAWAYS:

- Despite earlier interest rate increases and persistent inflation, fiscal policy and money transfers meant to cushion any potential slowdown due to the pandemic have supported consumer spending over the past three years.
- Consumers have been able to continue to spend because of the flow of income coming from employment.
- What happened after the COVID pandemic can only be described as pent-up “revenge spending”; however, excess savings have now been depleted. Nevertheless, if employment remains as strong as it is today, it should be sufficient to cushion the extent of economic activity weakness.
- Household debt has increased, but as a percentage of GDP it is still lower than during the Great Financial Crisis and the cost of debt servicing remains low.
- The consumer’s lifeline is income, and consumption is the backbone of all major developed economies. The consumer resilience contributed strongly to overall economic activity as economies emerged from the COVID pandemic recession.



First Look at the 2024 US Election: A 2020 Rematch?

Ed Mills, *Managing Director, Washington Policy Analyst*

The 2024 election is well underway and signs currently point to a 2020 ballot rematch between President Biden and former President Trump. An analysis of the dwindling number of competitive swing states shows just a handful likely to decide the outcome of the election—once again a potential repeat of 2020. The battle for majority control of the House and Senate is also showing signs of a close election, reflecting the slim majority in each house—likely decided on macro factors such as the winner of the presidential election, candidate quality, redistricting lawsuits, the economy, and views on the direction of the country. Control of both chambers of Congress remains important to the market, with tax cuts scheduled to sunset in 2025 and decisions on key judicial and regulatory confirmations awaiting the respective House and Senate majorities after the 2024 election. There are many wildcards ahead and we have lived through multiple elections where the conventional wisdom is upended more often than many of us would like to be reminded. In this update, we outline some of the market implications of the 2024 election and whether certain historical markers can give us insight into who might have the edge.

STATE OF THE PRESIDENTIAL RACE

At this stage in the race, President Biden is the expected Democratic nominee. On the Republican side, former President Trump has a sizable lead over his challengers for the Republican nomination. An analysis of voter preferences in previous nominating contests shows candidates with sizable leads at this point in the nomination process have all eventually captured their Party's nomination, making former President Trump the favourite to represent the Republican Party in 2024.

More than a year out from Election Day, we generally look at the approval ratings of incumbent presidents and polling on “right track/wrong track” of the country as a proxy for their strength and/or vulnerabilities for re-election. For President Biden, there are some warning signs for his re-election, as he has a net negative approval rating and a majority of voters viewing the US as on the “wrong track.” On the other hand, all incumbent presidents in the last 80 years have been re-elected, unless there is a recession.

This could make the trajectory of the economy over the next year particularly important for the re-election of President Biden. Other Democratic primary candidates have entered the race, but their candidacies do not pose a material threat to Biden's path to the Democratic nomination at this stage.

Concerns around Biden’s age have opened questions about what would happen if he had to drop out of the race. While an early withdrawal would see the Democratic National Committee (DNC) select a new nominee, a late-stage withdrawal would result in legal uncertainties around what electors can do. If Biden withdraws, a large field of both nationally prominent and rising star candidates are waiting in the wings.

As mentioned, we view former President Trump as the most likely Republican nominee, as the increasingly crowded Republican primary field is not yet presenting a real challenger to the former President’s significant lead in the polls. The outcome of various legal challenges for President Trump could alter the race, but we are in unprecedented times as it relates to these trials. As stated above, the approval rating of an incumbent president can be a proxy for the outcome of the general election and was a warning sign in 2020 for President Trump. There are a limited number of times where a former president has sought to win a second non-consecutive term and former President Trump also has a net negative approval rating similar to President Biden.

RACE FOR THE HOUSE AND SENATE

There are 34 of the 100 Senate seats on the ballot in 2024, with Democrats defending 23 and Republicans 11. Among the most competitive seats, all are currently held by a Democrat, including seats in Montana, Ohio, and West Virginia—all states won by President Trump in the last two presidential elections. The current 51-49 Democratic majority would flip if Republicans net two seats or one seat and win the presidency (as the Vice President is a tiebreaker). Candidate quality, which has been an issue in recent Senate races, will loom large in several of these, but with Senate races closely aligning with the presidential

A third-party run could further disrupt the playing field, acting as a ‘spoiler’ factor that could sap votes from the mainstream candidates and potentially swing the election

preference of the state, Republicans have an edge.

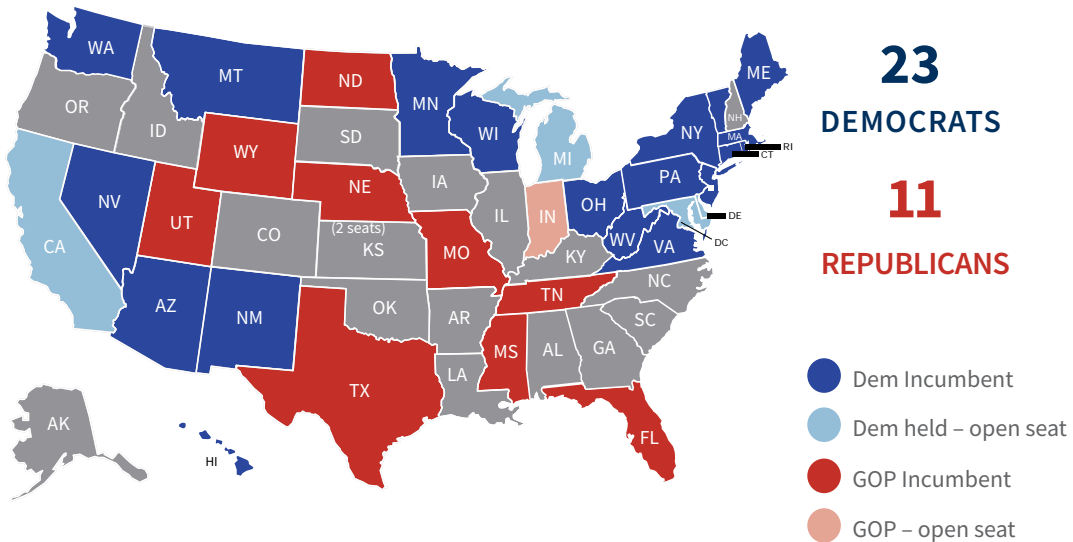
In the House, where all 435 seats are on the ballot, Democrats would have to flip six seats to win a majority. Historical precedent may provide tailwinds to Democrats, given that over the past 40 years, the House’ majority party (currently Republican) has lost an average of three House seats in presidential election years. At this point, the most important factors pertaining to the House are the ongoing court challenges to congressional maps, potentially switching several safe Republican seats over toward Democratic seats.

WHAT TO WATCH AND POTENTIAL WILDCARDS

The state of the race will continue to be fluid until the election, but key factors in the coming months will shape the race’s trajectory. As the 2024 cycle progresses, the primary debates will offer a key look into whether a challenger to former President Trump can emerge. Economic factors in the coming months will also play a critical role in determining the headwinds Biden faces, given that only four presidents have lost their second-term re-election bid in the last 80 years and all of them experienced recessions/lower consumer confidence during their first term.

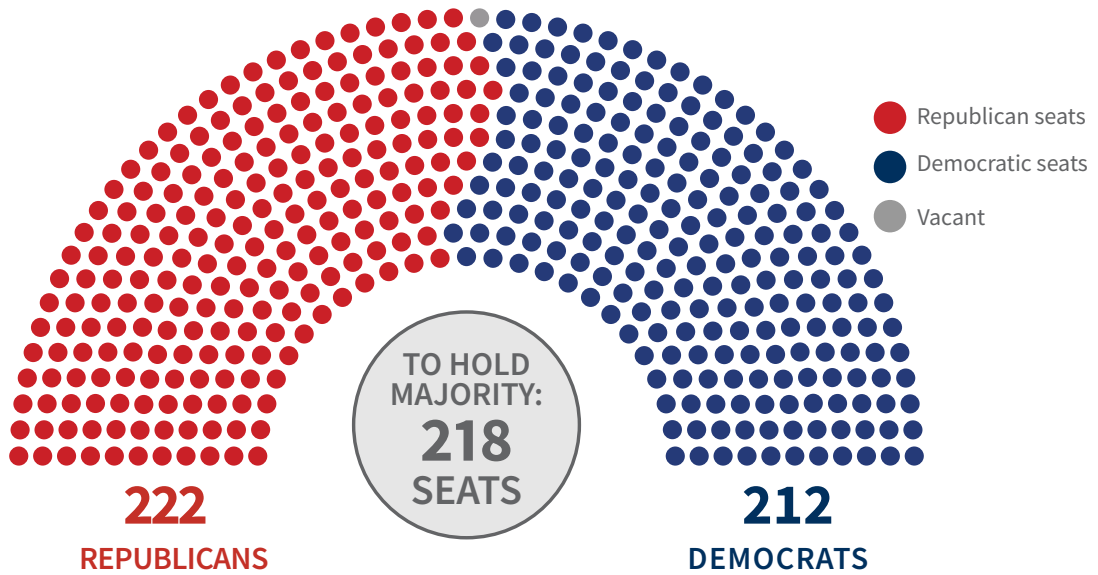
The Senate

CURRENT SENATE: 51 DEM, 49 GOP; DEM +1



Source: MapChart, Raymond James Research

The House of Representatives



Broader trends to watch include candidate quality in the race for the Senate, given Republican losses in close races (particularly in 2014 and 2022) by nominating candidates in key swing states with limited general election appeal. A third-party run could further disrupt the playing field, acting as a 'spoiler' factor that could sap votes from the mainstream candidates and potentially swing the election. Historical precedent has not seen third-party candidates receive electoral college votes on a material scale since 1968, but some polling data does confirm a

Key market issues for investors to watch will include headline risk around the appropriations process in Washington and the impacts of a potential government shutdown.

potential lack of enthusiasm among Democratic voters for Biden. A growing number of voters with preferences for outside candidacies or issue-specific platforms could gravitate to a third-party candidate.

As the electoral cycle progresses, other key market issues for investors to watch will include headline risk around the appropriations process in DC and the impacts of a potential government shutdown. As the divided Congress continues to debate funding levels and spending priorities for the 2024 fiscal year, we expect to see brinkmanship around the finer details, but view any funding impasse resulting from a shutdown as unlikely to have material near-term market impacts. However, potential dysfunction may impact voter sentiment down the line, with specific impacts on the Congressional race depending on how a potential shutdown unfolds. ■

KEY TAKEAWAYS:

- The 2024 presidential race is looking like a 2020 rematch between President Biden and former President Trump.
- Democrats hold a slim 51-49 majority in the Senate and are defending 23 Senate seats, so any losses could tip the balance of power.
- Republicans hold a majority in the House. Democrats would need to flip six seats to take control.
- Risk of a government shutdown continues to hang over Washington and will affect voter sentiment.



Adapting To A Water Shortage

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

Epic heat waves have been arguably the number one source of headlines around the world throughout this past summer: June 2023 was the hottest month in recorded human history... until it was topped by July. This is only the latest illustration of a long-term megatrend: global heating. Among the many consequences of the climate crisis is more widespread and severe droughts—or, to put it even more starkly, water scarcity. In thinking about the climate crisis, we need to differentiate between two types of responses: climate mitigation and climate adaptation. Mitigation is about how to keep the climate crisis from becoming even worse, with solutions that include shifting away from coal-fired electricity toward renewables and from the internal combustion engine toward electric mobility. This article, however, focuses on adaptation: how governments, businesses, and all of us as individuals need to adapt to the reality of rising temperatures. Arguably the most important aspect of adaptation pertains to the water industry's value chain.

WATER, WATER EVERYWHERE?

The International Institute for Applied Systems Analysis forecasts global water demand increasing by an average of 0.6% per year between 2010 and 2050, or 26% in total. By contrast, aggregate water availability does not change in any meaningful way over the long run. With this in mind, an important metric, calculated by the World Resources Institute, is what's known as baseline water stress. This is defined as total water demand (residential, commercial/industrial, agricultural) divided by water supply from conventional sources (rainfall and underground aquifers). The higher the ratio of those two numbers, the more water stress there is. Unsurprisingly, the situation is the most problematic in arid regions such as the Middle East. Looking at the G20 major economies, Saudi Arabia is at 5.0, followed by South Africa at 4.2. On the other end of the spectrum, Brazil and Canada have what we might call balanced water markets. The US at 2.6 and China at 2.8 are near the middle of the list. To be clear, that is the situation as it is right now — but it is getting worse just about everywhere. Demand growth is led by emerging markets, and a disproportionately large share of the incremental demand is coming from manufacturing rather than irrigation. The World Bank has predicted that water scarcity will afflict large swaths of Africa, the Middle East, and Asia by 2050, with a GDP impact of up to 6%.

At the risk of overloading our readers with technical lingo, we need to introduce another metric: water dependence ratio, which is defined as the percentage of total renewable water resources that originate outside the country. This pertains to the geopolitical dimension of water scarcity. As much of a "hot-button" issue as energy security has been in recent decades, water security is just as important, if not more so. In this regard, China is in a very good position, as its dependence ratio is a mere 1%. By contrast, India is at 31% and Pakistan at a whopping 78%. The latter two nuclear powers already have a rather strained relationship, to put it mildly, and competition for scarce water resources is only getting underway. Similarly, though without the risk of nuclear confrontation, it is not difficult to imagine water-related conflicts among several countries in Southeast Asia.

Water scarcity is a far-reaching problem that demands a wide variety of solutions to address it. We deliberately use the word 'address' rather than 'solve' — even under an optimistic scenario, this environmental challenge, like so many others, will be here to stay. Broadly speaking, the solutions can be divided into demand-side and supply-side categories.

WATER SCARCITY SOLUTIONS

On the demand side of the value chain, water usage can be optimised via improved planning and incentives, thereby

BASELINE WATER STRESS FORMULA

$$\frac{\text{Total water demand}}{\text{Water supply}} = \text{Baseline water stress}$$

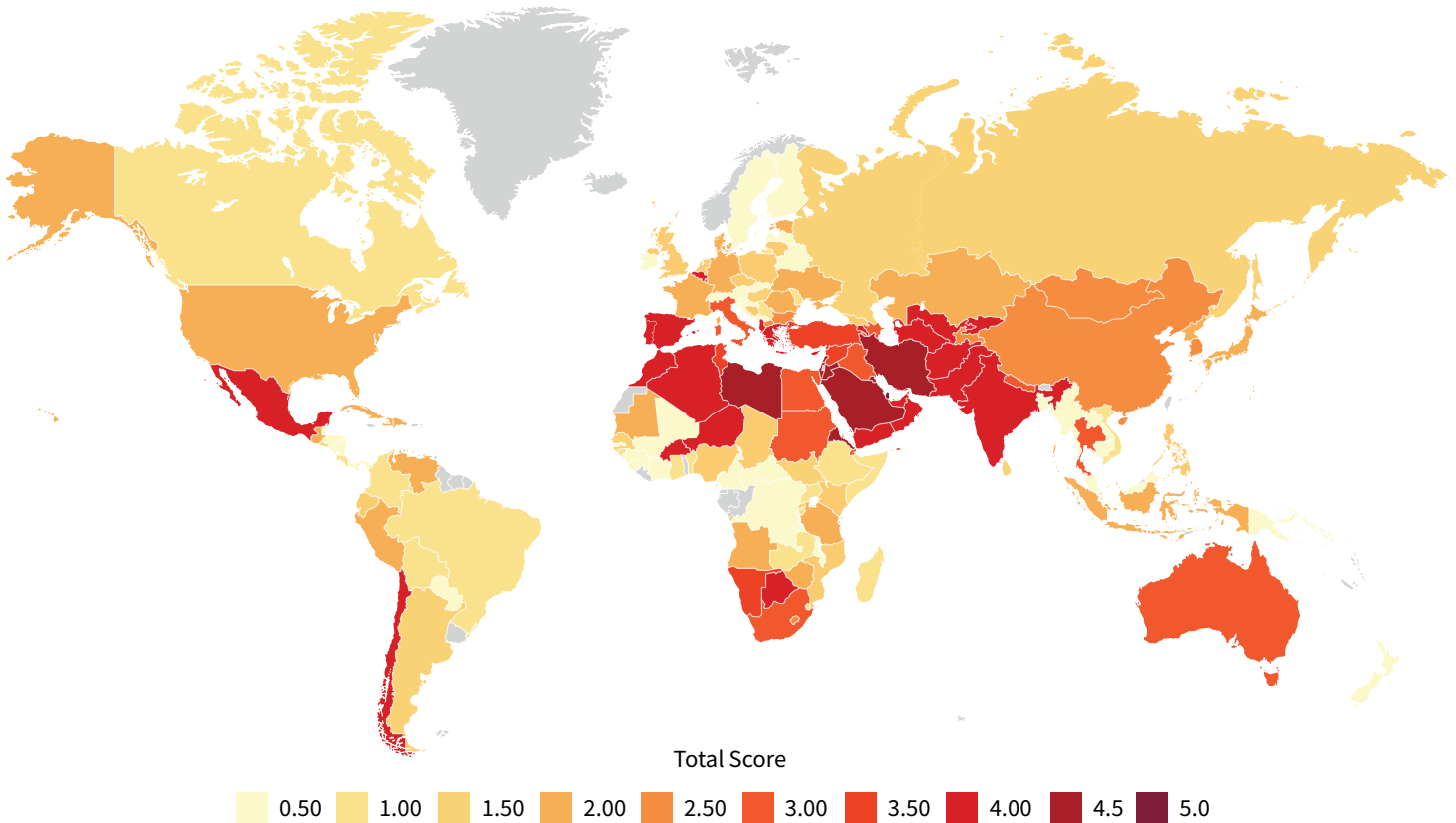
WATER DEPENDENCE RATIO

$$\frac{\% \text{ of water resources originating outside of the country}}{\text{Dependency ratio}}$$



avoiding the knee-jerk response of emergency rationing after a genuine crisis emerges. Some of our readers may remember the 'Day Zero' crisis in Cape Town, South Africa in 2018, though in terms of scale, it pales in comparison to what happened in Tamil Nadu, India in 2019 and parts of Pakistan in 2022. But even something as simple as water metering—a prerequisite for monitoring usage—is far from universal.

Water Stress By Country – 2023



Source: World Resources Institute

“More than one-third of the water provided by utilities in some communities is never actually paid for—it either disappears via leaky pipes or is erroneously measured.”

This, along with outdated drinking water infrastructure, helps explain why the amount of non-revenue water is as high as it is: estimated at up to 40% in emerging markets. In other words, more than one-third of the water provided by utilities in some communities is never actually paid for—it either disappears via leaky pipes or is erroneously measured.

The main supply-side solutions are wastewater recycling and desalination. Wastewater recycling, also called reclaimed water, can be used for non-potable purposes (e.g., agriculture) or direct human consumption. The latter tends to be controversial among the general public. Israel, Namibia, and Singapore are among the leaders in the percentage of water supply that is reclaimed. There is no fundamental reason why this technology cannot scale in China and India, but it remains a work in progress. As compared to wastewater recycling, desalination is more geographically widespread, though only 1-2% of the world’s population relies on desalinated water. Desalination has traditionally been most prevalent in the Middle East: Saudi Arabia and the UAE are near the top of the capacity rankings in absolute terms, and Israel and Malta have notably high shares of water supply coming from desalination. Adoption is on the rise in China and India, but less rapidly than you might think. During the period 2016-2020, China (population: 1.4 billion) built less desalination capacity than the UAE (population: 10 million), and India was even further behind.

HYDRO POWER: NO LONGER A GROWTH DRIVER

There is one final aspect of water scarcity that needs to be mentioned, and that is the impact on hydropower generation. Global heating translates into reduced flow of water in rivers, and that in turn leads to diminished hydro output. The impact on the world’s electricity supply—especially in the Western Hemisphere—is underappreciated. Hydro provides approximately 60% of the electricity in Brazil and Canada. Vietnam, Turkey, Russia, and

Argentina are all between 15% and 40%, and China—which has the world’s highest electricity consumption in absolute terms—is right at the global average of 15%. While it is too early to know for sure, there is a plausible scenario that global hydro output has already peaked. In other words, this portion of the electricity mix can never again be looked at as a growth driver. In this context, there is a crucial difference between hydro and non-hydro renewables. Wind and solar generation are intermittent on a short-term basis, but they do not face hydro’s structural headwinds. Thus, wind and solar need to play a role in displacing not only coal (a subset of climate mitigation) but also hydro (a case study of adaptation). ■

The World Bank has predicted that water scarcity will afflict large swaths of Africa, the Middle East, and Asia by 2050, with GDP impact of up to 6%.

KEY TAKEAWAYS:

- Water security is a geopolitical issue like energy security.
- Water stress is most problematic in the Middle East and parts of Asia, but it is worsening everywhere over time.
- Water usage can be optimized via improved planning and incentives, thereby avoiding the knee-jerk response of emergency rationing after a genuine crisis emerges.
- The main supply-side solutions are wastewater recycling and desalination.



Pension Planning

James Brooks, *Deputy Head of Business Development, Raymond James Investment Services Ltd**

On 15 March 2023, chancellor Jeremy Hunt gave a speech outlining his spring budget. In it, he announced a number of changes designed to stimulate economic growth and manage inflation.

He aims to achieve this is by encouraging retirees to come back to work and keep those approaching retirement age in work for a few more years. As a result, several changes to pensions legislation came into effect on 6 April 2023.

This article is designed to give you an idea of how these changes may interact with your own personal situation. It is important that you understand what has changed and how it may affect you, so you can take full advantage of all the appropriate allowances.

Please note, that the detail provided below is for information purposes, and does not constitute advice. No action should be taken with regards to your pension without consulting a suitably qualified and regulated person.

THE LIFETIME ALLOWANCE HAS BEEN EFFECTIVELY ABOLISHED

The lifetime allowance (LTA) is the total amount of pension savings you can accumulate in your lifetime without incurring a tax charge. Changes to the LTA were expected but the chancellor surprised many people by announcing that it will be abolished at the end of this tax year.

In the 2022/23 tax year the LTA was £1,073,100. Some people will have a higher lifetime allowance due to applying for LTA-protection. Depending on your circumstances and any previous protection you would have faced additional tax charges when you came to withdraw any pension savings above this limit, or at age 75 if benefits remained untouched.

This may have encouraged some people to retire instead of staying in work because they had reached the LTA and it was no longer tax advantageous to contribute to their pension.

In the budget, Jeremy Hunt announced plans to abolish the LTA in the future, which is positive news for many. This means you can contribute more to your pension without facing a tax charge when you come to taking benefits. It could also make your pension a more effective vehicle for tax planning and reducing a potential Inheritance Tax (IHT) bill for your family. Although it will not be officially abolished until the end of this tax year, the LTA tax charge was removed on 6 April 2023.

IMPACT ON LIFETIME ALLOWANCE PROTECTION

The abolition of the lifetime allowance has meant that rules have changed for those who applied for protection of their LTA. There are many different types of protection which will not be covered in detail here, but the changes in legislation have meant the greatest impact is on individuals who applied for fixed protection.

Those with fixed protection will have had a larger lifetime allowance than the standard rate set by the government. It has since been confirmed that those with LTA protections will still be entitled to 25% tax-free of their enhanced LTA. It has also since been confirmed that if you had applied for fixed protection before 15th March 2023, you could resume contributions to your pension without losing your higher tax-free cash entitlement.

You will have unused annual allowance from previous years which you may be able to carry forward. Please speak to your Raymond James wealth manager about this.

ANNUAL ALLOWANCE INCREASED FROM £40,000 TO £60,000

The chancellor announced the upper threshold for the annual allowance will be raised from £40,000 to £60,000 from the start of the 2023/24 tax year. The annual allowance is how much you can contribute to your pension and receive tax relief.

This is a complex area of pensions as an individual's annual allowance is based upon how much they earn. You only receive tax-relief on contributions up to 100% of your earnings, up to a limit of £60,000. If you have no earned income, you can still contribute £3,600 per annum to your pension. If you are a high earner, you may have your annual allowance reduced. This is known as the tapered annual allowance.

MINIMUM TAPERED ANNUAL ALLOWANCE INCREASED FROM £4,000 TO £10,000

The tapered annual allowance (TAA) limits the tax relief that high earners can receive on their pension contributions.

If your 'adjusted income' – your total income plus employer pension contributions – is more than £260,000, your annual allowance will normally be reduced by £1 for every £2 that you exceed the threshold. The threshold was raised from £240,000 to £260,000 on 6 April 2023. The minimum tapered annual allowance has been increased from £4,000 to £10,000 meaning if you are earning over £360,000, you will be limited to paying £10,000 into your pension each year.

MONEY PURCHASE ANNUAL ALLOWANCE INCREASED FROM £4,000 TO £10,000

The money purchase annual allowance (MPAA) is triggered once you start drawing income from your defined contribution (DC) pension. This limits the amount that you can then contribute to your pension while still receiving tax relief.

The MPAA was raised by the chancellor from £4,000 to £10,000 to provide an incentive to those who had retired and drawn income from their pensions to go back to work.

PENSION COMMENCEMENT LUMP SUM NOW CAPPED

The maximum amount most savers can currently take as a pension commencement lump sum is 25% of their available lifetime allowance when this sum is taken.

After the removal of the lifetime allowance charge from 6 April 2023, the maximum tax-free cash available to an individual will be £268,275. This will only be applied to those who have pension pots valued at over £1,073,100.

OUR VIEW

At Raymond James we have identified that the tax benefits for increasing contributions had now increased significantly, in fact, by tens of thousands of pounds. Along with the abolition of the LTA a change in strategy could create a significant improvement to our clients' financial position.

These changes mean that you may be able to make more tax-efficient contributions to your retirement savings. Another key benefit is, due to pensions usually being outside your estate for inheritance tax purposes, the changes to legislation can allow for more estate planning opportunities.

There are still certain rules like the TAA and the MPAA that could reduce the amount of tax relief you receive, and it is important that you understand and seek advice as to whether you are affected or not.

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There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

US government bonds and Treasury bills are guaranteed by the US government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. US government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. Treasury bills are certificates reflecting short-term obligations of the US government.

While interest on municipal bonds is generally exempt from federal income tax, they may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Municipal bonds may be subject to capital gains taxes if sold or redeemed at a profit.

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Investing in REITs can be subject to declines in the value of real estate. Economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

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Beta compares volatility of a security with an index. Alpha is a measure of performance on a risk-adjusted basis.

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Pension Planning

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