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Letter from the Chief Investment Officer

Time Is On Our Side

Start me up! Why would this iconic Rolling Stones song keep racing through my mind? Because it seems like the drivers of this turbulent market—Federal Reserve tightening, inflation, recession worries and geopolitical fears—feel like they will *never stop*. They seem to have more staying power than lead singer Mick Jagger (who turns 80 in July). As we dig deeper into our more optimistic market and economic views, we'll unearth relevant lyrics from some of the Stones' impressive 422-song portfolio to make our case. With equities struggling and interest rates moving higher, investors could be seeking some *emotional rescu*e. But *time is on my side, yes, it is*, for two reasons. First, we believe we are closing in on the end of the equity bear market, peak yields, and Fed hawkishness. Second, we expect investors to be rewarded for enduring the current volatility as it should lead to robust performance for most asset classes in the long term.

The US economy remains resilient, driven by the *wild horses* of consumer spending. While consumers are shifting spending from goods to services, overall spending continues at a healthy clip. But three factors—dwindling excess savings, higher interest rates and softening job creation—should curb growth soon. Despite the outsized job gains in January and February, economic undertones suggest employment gains are already slowing. Withholding taxes' growth has slid lower on a year-over-year basis, companies have begun to lay off employees (particularly in tech-related businesses), and both online and professional recruiters have lamented slackened hiring. Indeed, the unemployment rate could climb near 5% from its current level of 3.6% by year end. Weakened consumer consumption is one reason our economist expects a mild recession in the second half of this year.

Another recession reason: The Federal Reserve (Fed) kept raising interest rates because it *can't get no satisfaction* with inflation until recently. Look for possibly another rate hike in the fed funds rate to 5.25% at the May meeting. The problem is this: Monetary policy acts with a lag of approximately one year. So, much of the economy is just starting to feel the impact of the first interest rate increases from about a year ago. As we progress further into the year, the accumulation of these rate boosts will crimp both capital spending and consumer spending. We've already seen a bit of this *beast of burden* in the Silicon Valley Bank failure. While we believe the SVB fallout will be contained before things go *all the way down*, it's an example of the Fed squeezing... until things break. This year, there will be little, if any, help from Washington as lawmakers focus on the battle to avoid a government shutdown over the debt ceiling. We believe they'll avert a shutdown at the eleventh hour—as usual.

In bonds, investors have complained for decades that *you can't always get what you want* when it comes to higher interest rates and meaningful income. But wait... now you can… with interest rates soaring to levels not seen since 2008. The rate reset has flipped the script to focusing on attractive yields rather than stretching for yield in lower-quality bonds. Indeed, this is not simply a feature limited to the US as yields have risen across developed economy sovereign bond markets. In addition, improved yields afford investors the ability to balance their portfolios better. But the higher interest rate opportunity probably won't last long. We are still forecasting the 10-year Treasury yield to head lower toward 3.00%. Lower rates will enhance the returns of the sectors we favour, including Treasurys, municipal, investment grade, and emerging market bonds. We still shy away from lower-quality high yield bonds; their yields aren't compensating investors for the threat of a recession.

Equity markets want the Fed and inflation to *get off of their cloud*. Why? Because equities tend to rally when the Fed ends its tightening cycle, inflation decelerates, and interest rates fall. Assuming the Fed doesn't overtighten and take the economy into a severe recession, S&P 500 earnings should remain solid around $215. If anything, the economy's better-than-expected start this year gives us more confidence in the upside potential of those numbers. A weaker dollar, quickly improving supply chains, and easing commodity and labour costs should help support margins. The current decline in equities has likely already priced in a mild recession. When we finally get to the recession, sentiment should turn more positive—as markets anticipate coming out of it. As these factors

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improve, stock markets on both sides of the Atlantic Ocean should move higher. While selectivity remains paramount, given the economy's transition, we continue to favour Technology, Health Care, and Financials, among others.

Internationally, we still favour the US over other developed markets. Europe has been like *Jumpin' Jack Flash* in a *crossfire hurricane* given its proximity to the Russia/Ukraine war. Europe has managed to navigate the effects of the war for now, thanks to the warm winter and unprecedented shift away from Russian natural gas. But the euro zone's recovery must survive tighter monetary policy as European Central Bank hawks focus on stubborn inflation and a tight labour market. Higher rates and a housing downturn may expose vulnerabilities in countries geared to shorter-term mortgages. While both the euro zone and the US will likely experience a recession, history suggests American companies are more adept at navigating slowdowns. Emerging market equities remain attractive as China has not yet felt the full boost from its much-touted post-COVID reopening, but the potential for robust growth still exists. If oil reaches our $90/barrel year-end target, Latin American equity indices should benefit.

The last year or so has been challenging for investors, with many assets, from fixed income to equities, still in the red. But we see that red and want to *paint it black*. If our assessment is correct, we are past the bottom in both the equity and fixed income markets, and we'll probably see performance improve into this year and next. Short-term volatility may rattle markets, but a focus on diversification and asset allocation should help guide us through those threats. As always, your financial advisor is there to take the lead or serve as backup to help harmonise your portfolio. Remember: patience and a long-term focus are vital. After sixty years, the Rolling Stones are still touring and filling stadiums—with Mick Jagger singing and Keith Richards still going on the guitar! Like them, focus on continuing success over the long run!

It's only rock 'n roll, but I like it!

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

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Can the UK Escape the Economic Slow Lane?

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

As every Chancellor of the Exchequer surely knows, the best Budgets are those in which the incumbent struts and frets their hour upon the stage and then are seen (or heard) no more. On this occasion Mr Jeremy Hunt "lucked out" insofar as his speech and its implications for the UK economy's near-term outlook were entirely overshadowed by events unfolding in the banking sector, both in the United States and Europe. However, for those sufficiently interested in prospects for embattled UK economic activity there was much to pore over. Billed as a "Budget for Growth" the measures announced do go some way towards extricating the country from its immediate travails, however, a coherent plan for the longer term is required over and above laying the foundations for the next election campaign.

Following the UK administration's autumn crisis, the first requirement deemed essential for the incoming Chancellor was a cool nerve and a steadying hand on the country's purse strings. Mr Hunt has so far excelled himself, delivering sensible economic prescriptions when the economy needed them most. Fiscal credibility may not yet be fully restored, but the return to calmer waters for the domestic gilt-edged government bond market and sterling's rediscovered stability on the foreign exchanges illustrate the extent to which important steps are being taken in the right direction.

This Spring Budget, more than simply adding greater stability to a hitherto listing ship, provided the opportunity for the implanting of foundation stones aimed at constructing a new economic framework and faster economic growth in the future. For the immediate present, a package measures widely trailed in advance, amounted to a £21.9bn "giveaway" over the 2023/24 fiscal year, rather more generous than had been anticipated. Beyond that, measures costing the Treasury a net £10.4bn out to 2027/28 was unequivocally better news than pessimists had expected. In passing, and of interest to everybody, the unquestionable highlight was the decision to cancel the scheduled 20% increase (£2,500 to £3,000) in the Energy Price Guarantee as it relates to all utility bills from 1st April. The subsidiary decision to scrap a 23% increase in forthcoming fuel duty was also well received and will further ease the country's long-standing cost of living crisis.

In consequence of these measures the Office for Budgetary Responsibility (OBR) is no longer forecasting a recession in 2023 and growth estimates for 2024 have been marked higher. This is highly significant as the OBR's previous assertion, that the UK economy would enter recession in Q3 of last year and that it would last for five quarters garnered considerable negative attention. It is now thought likely that while a slide into mildly negative territory is inevitable over the first quarter of the current year (once lagging data is made available), a slow revival should take place thereafter to the extent that real GDP growth will emerge at just -0.2% once data for 2023 is published, rising to +1.8% in 2024. These upwardly revised expectations are +1.2%-points and +0.5%-points respectively higher than November's forecasts.

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Concomitant with upgraded forecasts for the UK's economy, the OBR delivered more good news in relation to the outlook for the public finances which percolating down, produced a windfall of £27.9bn enabling the Chancellor both to meet his fiscal rules (just) and to dispense rather more largess than had been expected. The Budget mathematics reveals yet more positivity in the form of medium term fiscal projections which include notably lower public borrowing than outside independent observers could have hoped for.

It goes without saying that, when staring into the future the risk to the country's reviving public finances is that the economy fails to deliver against reinvigorated expectations. The most obvious threat lies in either an acceleration in the issues affecting the global banking sector (although apparent Bank of England insouciance reflects the extent to which the UK's central bank believes that domestic banking entities are sufficiently resilient and ringfenced to withstand any escalation of the crisis) and/or the impact of a continuation in the now fairly prolonged downward trend in commercial bank lending and the provision of credit. It is noteworthy, in passing, that the OBR's forecasts do not include any provision for any possible additional deterioration in the prevailing situation.

In his speech to parliament when announcing the Budget proposals, the Chancellor reiterated his desired industrial strategy based upon four pillars: Education, Employment, Enterprise and Everywhere. With regard to the first two, Mr Hunt introduced measures aimed at addressing the UK's apparent shortfall in labour supply, a broad suite of initiatives reflective of the wide-ranging nature of the problem. These may, or may not prove effective over the short-term, but it is the UK economy's health over the medium-to-longer term that matters just as much and here we find ourselves revisiting some very familiar territory. That the UK economy faces serious structural challenges is beyond doubt. Equally, the intractable nature of these challenges is reflected in the fact that there is no "silver bullet" and no easy answers. Had there been they would surely have been deployed by now.

In an attempt to simplify that which fundamentally ails the UK the issues boil down, loosely, to the size of the labour force, the capital provided to that labour force and the efficiency with which the labour force puts that capital to work, productivity in short.

Where does the country stand? Firstly, the UK's labour force is smaller now than it was at the start of the pandemic and smaller still than it was prior to the Brexit referendum. This places the UK in a fairly unique position matched only across developed economies by Italy and Japan (where demographics and an ageing population have played a key role). Secondly, the UK suffers the lowest rate of investment across G-7 economies and thirdly, labour productivity has plunged to multi-decade lows.

It goes without saying that all proposals put forward to improve the UK economy's prospects must address each of these issues and not individually, but collectively.

To say that this is a complex undertaking represents a serious understatement. Reforms are likely required both as they pertain to the labour market (including to pensions, housing and the provision of childcare). Reform is also required to promote and boost investment and more specifically that targeted investment likely to achieve a lasting improvement in productivity. Easier said than done. Promoting investment, for example, requires the funding from an equivalent increase in savings, which might involve an overhaul of the tax system in addition to the pension industry. Whilst the knock-on benefits from such reforms might also boost the labour supply in addition to achieving the desired improvement in productivity, it is pretty clear that profound adjustments involving complex interlinkages will not be taking place overnight and seem more likely to be measured in decades, not months or years. Reforming the UK is a huge, but necessary challenge. Establishing a cohesive long-term approach can only be achieved over a number of parliaments and requires, in the first instance, a preparedness on the part of all political parties to work together. Garnering such cross-party support in an age of confrontation feels like the vain struggle of aspiration over experience. But despite this a goal does exist and it can be reached not in terms of narrow-minded political party point-scoring but in a spirit of mutual cooperation and a willingness to work together for common prosperity in the future.

KEY TAKEAWAYS:

- The Spring Budget delivered a package of measures likely to boost the UK's near-term economic performance.
- The Chancellor has articulated the foundation stones necessary to underpin the UK economy's longer-term revival.
- But achieving an increase in the size of the labour force and the targeted investment necessary to deliver productivity improvements are both complex and interlinked.
- Achieving the necessary root and branch reform requires aspiration and will take time. Prolonged cross-party cooperation, a big ask in the current atmosphere of elevated political antagonism would be an important first step.

Labour Force Participation: Where Did the Workers Go?

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

UK editors note: Whilst necessarily US-centric we reproduce this interesting analysis as many of the themes contained within pertain also to the UK and other developed global economies more generally.

Labour force participation refers to the percentage of the population who are either employed or actively seeking employment. Overall, labour force participation has declined in the US over the past several decades. Labour force participation for men has been steadily declining since the 1960s, and only the staggering number of women joining the workforce has allowed labour force participation to increase over the years. Labour force participation peaked at 67.3% in 2000, when women's participation also peaked, and steadily declined until 2015, when real wages and salaries seemed to have worked their magic to bring more individuals into the labour force. That is, higher real wages incentivised workers to join the workforce and brought labour force participation up slightly. The COVID-19 pandemic caused a significant drop in labour force participation, but the US labour force is still 0.8% lower than what it was pre-pandemic, so where did all these people go?

> As of August 2021, there were slightly over 2.4 million excess retirements due to COVID-19, which is more than half of the 4.2 million people who left the labour force from the beginning of the pandemic to the second quarter of 2021.

There are many hypotheses surrounding the whereabouts of the missing workers, and it's unlikely that economists will have a more precise answer for years to come. However, we believe that most of these missing workers are a combination of early

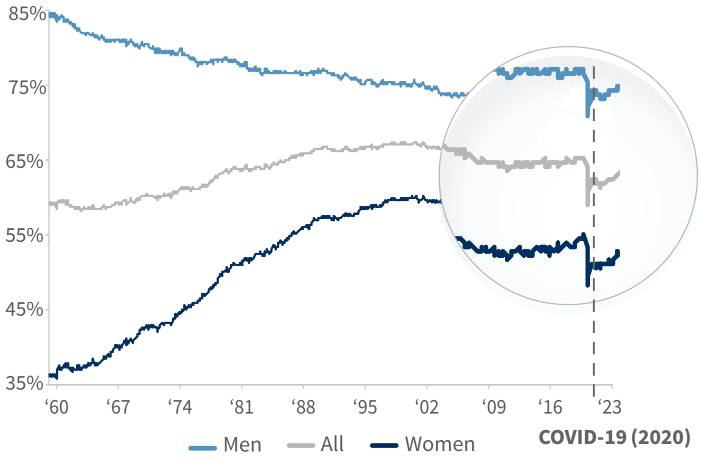
 Endnotes are listed on Page 20.

retirees, individuals who passed away from COVID-19, those with long COVID, a reduced number of immigrant visas, men/women working from home during the pandemic who resigned and left the workforce once asked to go back to the office, as well as workers whose opportunity cost to return to work outpaced the monetary benefits.

Early Retirees: The stock market rally in 2021 is likely to have boosted retirement savings for many Americans at and about to reach retirement age. This sudden and unexpected boost in wealth has probably allowed many to weigh their options and consider leaving the workforce early. Some people, especially those with pre-existing medical conditions, may have had health concerns about returning to workplaces and catching the virus. On the other hand, others might have just opted to downsize and move to a location with a lower cost of living rather than spending additional years accumulating wealth.

An Economic Synopses publication from the Federal Reserve Bank of St. Louis indicates that "As Baby Boomers began retiring, the percentage of retirees in the US population grew to 18.3% in February 2020, the eve of the COVID-19 outbreak. The percentage then increased at a much faster rate, reaching 19.3% in August 2021."[1] In this research paper, the author estimates that the difference between the 'normal' rate of retirement and the 'excess' retirement rate after February 2020 was higher by about 0.9%. "Based on those numbers, as of August 2021, there were slightly over 2.4 million excess retirements due to COVID-19, which is more than half of the 4.2 million people who left the labour force from the beginning of the pandemic to the second quarter of 2021."

Labour Force Participation



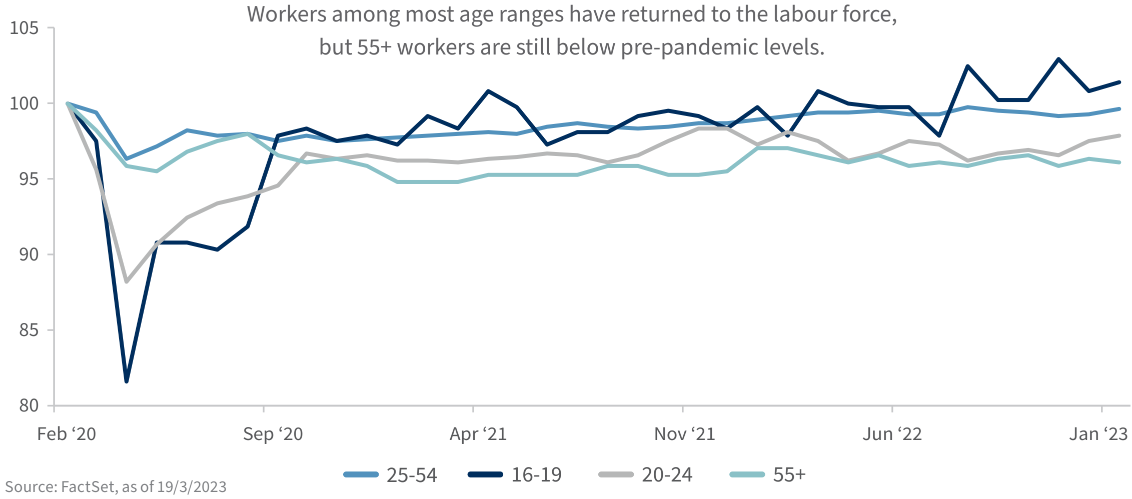
Source: FactSet, as of 17/3/2023

Long COVID: In addition to those who passed away from COVID-19, there are many estimates of how many people are suffering from long COVID and are unable to work. We have seen estimates of this number at between one and five million Americans. Research by the Brookings Institution's Hutchins Center has this number at between 281,000 and 683,000.[2] However, another report from the Brookings Institution in August of 2022 reported that "new data shows long COVID is keeping as many as four million people out of work."[3] However large or small this number is, it is clear that long COVID may be a contributor to today's still low labour force participation rate.

Immigration: The US issued well over eight million visas yearly between 2012 and 2018. However, the COVID-19 pandemic caused a significant decline in immigrants legally able to work in the US. Overall, in the last three calendar years combined, there have been between eight and ten million fewer legal immigrants added to the workforce.

Older Workers Aren't Coming Back

Workers among most age ranges have returned to the labour force, but 55+ workers are still below pre-pandemic levels.



Source: FactSet, as of 19/3/2023

Opportunity cost: For those who were able to work remotely, returning to an in-person job can be costly, especially for families with young children, older parents, or those in other circumstances where a worker's presence at home would be beneficial. In fact, sometimes the higher cost of services such as childcare and eldercare wipes out the benefit of having a dual-income household. Additionally, many families enjoyed the flexibility of working from home, and many are having a hard time giving it up. According to the Federal Reserve Bank of St. Louis, "the proportion of the population that reports being out of the labour force because of home care/family care" has increased considerably and has remained high after the end of the pandemic.[4]

WHAT IS THE IMPORTANCE OF THE LABOUR FORCE FOR MONETARY POLICY?

A study by economists at the Federal Reserve Bank of Chicago in 2014 concluded that "the results from our models suggest that there may indeed be greater slack in the labour market than is signalled by the unemployment rate."[5] The importance of this finding at the time was that "the existence of such extra slack might imply that it would be appropriate for monetary policy to remain highly accommodative for longer than would otherwise be the case." In fact, the view that there was a larger labour slack during the pre-COVID-19 pandemic period kept the Fed highly dovish even in the face of very low rates of unemployment, as this greater slack in the labour market reduced the possibility of experiencing increases in wages and salaries that would have jeopardised the pursuit of the Fed's inflation target of 2.0%.

Today, the question of whether there is more or less slack in the US labour market is one of the most consequential questions for monetary policy going forward, as it will determine how high and for how long the Fed is expected to remain hawkish/dovish on the inflation front.

> We expect the Fed's stance to remain hawkish for longer, rather than return to a more accommodative stance.

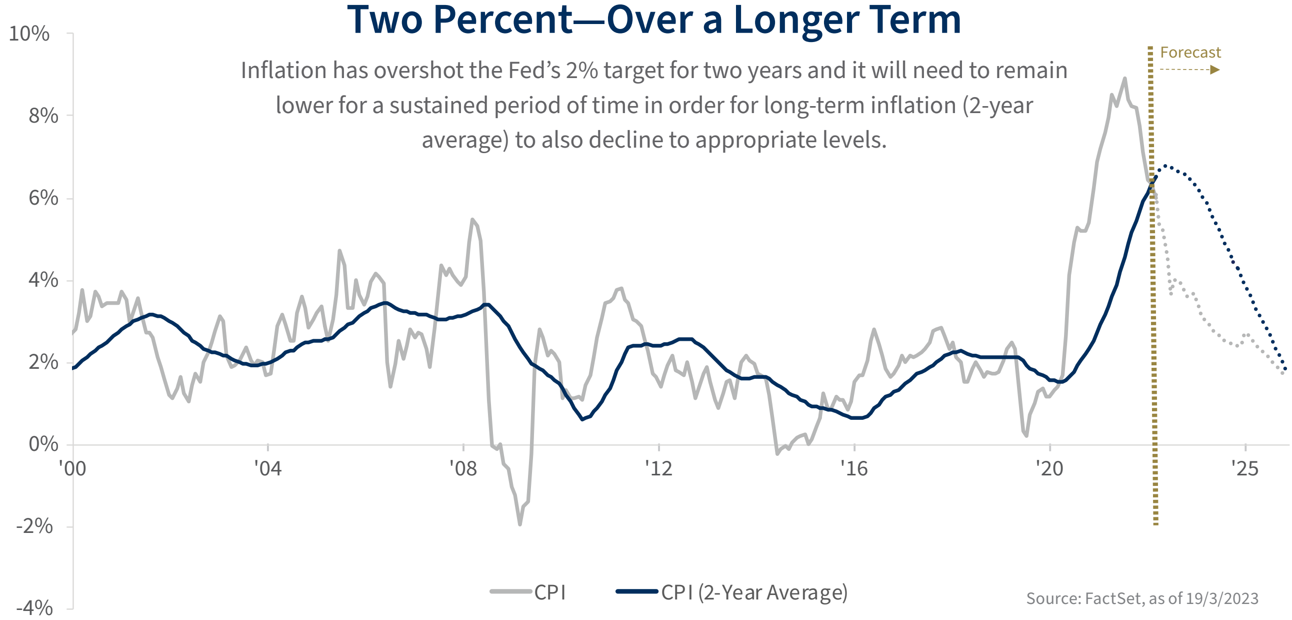
New research has been published since the start of the COVID-19 pandemic addressing the potential changes that occurred in the US labour force. One of these papers, published in 2021 by economists at the Federal Reserve Bank of San Francisco and titled "The Divergent Signals about Labour Market Slack," argued that "The COVID-19 pandemic has disrupted the US labour market, causing unprecedented deviations from the normal historical relationships among a wide range of labour market variables. Indicators related to the manufacturing and small business sectors as well as to overall labour turnover suggest that there is less slack in the labour market than is reflected in the unemployment rate. By contrast, measures of labour force participation and the duration and reasons for unemployment all show more slack than the unemployment rate."

Another research paper concentrated on the effects of the Great Resignation on labour market slack and inflation, concluding that "by applying for jobs in a different firm, employed workers can spur wage competition between the current employer and prospective employers. As a result, labour becomes more expensive to retain or to hire, effectively corresponding to a tighter labour market from the perspective of employers."[6]

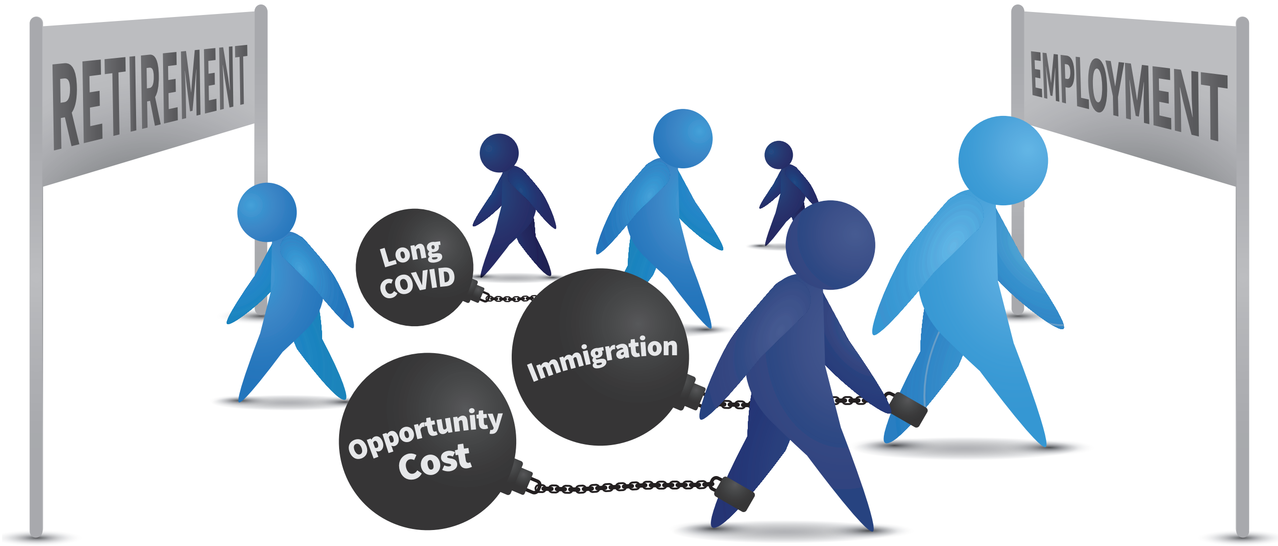
Meanwhile, economists at the Dallas Federal Reserve wrote a research paper that also pointed to a tighter labour market than before the COVID-19 pandemic, saying that "Many employers throughout our district report that they are struggling to rehire

Two Percent—Over a Longer Term

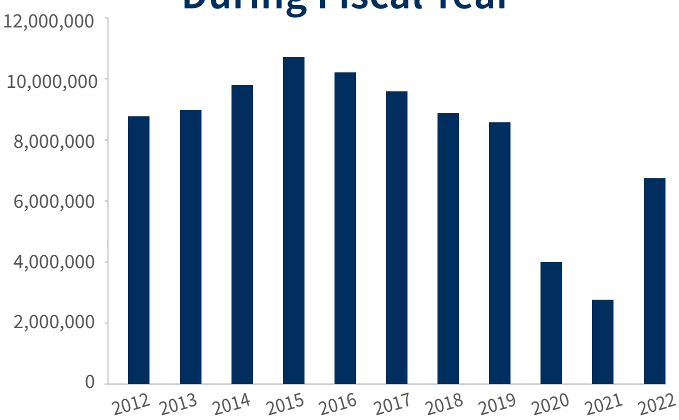
Inflation has overshot the Fed's 2% target for two years and it will need to remain lower for a sustained period of time in order for long-term inflation (2-year average) to also decline to appropriate levels.



Source: FactSet, as of 19/3/2023



Total US Visas Issued During Fiscal Year



Source: FactSet, as of 19/3/2023

former employees as the economy reopens, as many of their former employees are reluctant to return to their old jobs."[7] The research points out that these factors will probably fade out in the future but that this is not guaranteed.

The Fed has allowed the rate of inflation to overshoot its 2% target for two years and now need to push this 'over the longer-run' average down as fast as possible. In fact, as we have said before, the Fed will probably have to undershoot the 2.0% target on inflation for several years in order to achieve its 2.0% target 'over the longer run.' Thus, one of the factors potentially threatening this strategy is the strong US labour market. For this reason, we expect the Fed's stance to remain hawkish for longer, rather than return to a more accommodative stance in the short to medium term. Although many of the reasons for individuals not coming back into the labour force are almost impossible for policymakers to affect, the immigration issue is one of those partial solutions that could help increase the labour force participation rate and is in the purview of the political establishment to achieve.

KEY TAKEAWAYS:

- Labour force participation refers to the percentage of the population who are either employed or actively seeking employment. Overall, labour force participation has declined in the US over the past several decades.
- The COVID-19 pandemic caused a significant drop in labour force participation, we are still 0.8% lower than what it was pre-pandemic, so where did all these people go?
- Most of these missing workers are likely a combination of early retirees, individuals who passed away from COVID-19, those with long COVID, a reduced number of immigrant visas, and those who worked from home during the during the pandemic and don't want to return to the office.
- The question of whether there is more or less slack in the US labour market is one of the most consequential questions for monetary policy going forward, as it will determine how high and for how long the Fed is expected to remain hawkish/dovish on the inflation front.

Competition and Conflict: Market Impacts of Rising Geopolitical Risk

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

Markets are navigating a new global era. US-China tensions, COVID, and the war in Ukraine have highlighted that geopolitical risks are on the rise and becoming a more prominent part of the macro investment decision-making process. 24 February marked one year since Russia's invasion of Ukraine, prompting policymakers and investors to take stock of how the conflict has progressed, how it could begin to wind down, and what risks remain. The COVID-19 pandemic exposed domestic capability/production gaps, increasing focus on resiliency (and changing US industrial policy). The US-China relationship has raised concerns about a 'new Cold War' and a decoupling of the world's two largest economies. These national security issues have been increasingly difficult for investors to manage and deserve continued attention.

RUSSIA-UKRAINE WAR

A new major land war in Europe has renewed concerns over 'great power' conflicts versus the regional threats that the world and markets have navigated in the post-World War II era. Looking back over the last year, the war's macro impact on the market and global economy has elevated geopolitical risk premiums and threatened disruptions for key global commodities. The two most impacted areas have been energy and defence—a trend we expect to continue. As we move into year two, attention will focus on whether an off-ramp becomes clearer and market pressures ease, or if the larger geopolitical risk premium is here to stay. An optimistic assessment sees the war de-escalate toward a potential ceasefire and the beginning of a resolution process around the third quarter, but we caution that the first half of this year will continue to see a heightened risk of escalation that can drive periods of volatility.

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Ukraine's armed forces have reclaimed about 50% of territory captured by Russia. The success and stability of Ukraine's defence—

which was not a given at the start of the war—has prompted western nations to increase their support for Ukraine's military and economy with total US support reaching around $113 billion (about 0.5% of US GDP). However, we view the spring and summer as a potential turning point in the war. Advances by both sides are expected to slow substantially, potentially settling into a frozen conflict on the nearly 600-mile front in eastern Ukraine. Should this occur, the question for markets will be whether conditions support the start of a resolution process. Recent headlines have indicated that western leaders are beginning to plan around a post-war scenario, and the key factors that could form an off-ramp are twofold:

1. *Will Ukraine and western allies see any move toward a peace settlement as durable and sustainable?*

2. *Will Russian president Vladimir Putin assess that the costs of continuing the war outweigh the benefits?*

Both of these factors support a period of heightened escalation potential before any off-ramp becomes a clearer possibility. Ukraine and the western coalition will look to increase the costs for Russia to deter similar action in the future, and Russia is likely to challenge western unity and solidify control over currently occupied territory to increase its leverage in any settlement negotiations. This generally positions the first half of this year as an 'escalate to de-escalate' setup—a military strategy term which can be adopted to fit the trajectory of the conflict. We would expect market volatility at the beginning of any escalation, but any off-ramp would be viewed as a market positive.

It is also important to consider less optimistic paths. The two more concerning possibilities include a protracted war that continues to place a drag on global economic growth and an expansionary conflict that sees a direct confrontation between NATO forces and Russia. A principal Russian goal would be to degrade support for Ukraine among western allies. An environment of persistent inflation, mounting domestic fiscal challenges, and no end in sight to the conflict could weaken unity among western allies and ease Russia's path toward heightened regional power. A more escalatory path to the conflict involves a decision by Russia's policymakers that a war lost to NATO directly is less damaging to the stability of the Putin regime than losing a war to Ukraine. While this path may be unlikely at this stage, the range of possibilities related to the conflict warrant continued caution given the level of uncertainty ahead.

Even as markets look to a potential post-war scenario, we expect certain sector impacts to be longer lasting. Particularly, energy and defence trends are undergoing a structural transformation driven by the longer-term policy implications of the war. For energy, part of the war's impact has been an expansion of national security concerns around economic linkages from advanced technology prior to the invasion to include legacy and mature sectors with high concentration risk. Oil, natural gas, and energy infrastructure are likely to see persistent policy impacts as the availability and expansion of these economic inputs is more acutely seen as a core national security interest. This trend is likely to drive new investments into securing and diversifying energy supplies with a focus on avoiding concentrations that could lead to future vulnerabilities, such as with critical minerals for renewables technologies.

Energy and defence trends are undergoing a structural transformation driven by the longer-term policy implications of the war.

On defence, global military spending will be on a longer-term growth trajectory as governments invest in military capabilities to deter new wars and conflicts among nations. The Biden administration's recent National Security Strategy describes the decade ahead as "a significant inflection point" that sees renewed tensions between global powers. From a US standpoint, investment in defence will particularly be driven by the desire among policymakers to project a credible degree of capability for the US to defend its security interests in multiple hotspots as this global competition increases. A recent expansion and escalation of tensions with China will be a further tailwind for increased defence spending, in our view. A lesson learned from Russia's invasion of Ukraine is that the threat of severe economic sanctions is not sufficient as a means of deterrence, which will place renewed emphasis on military power as a critical national security consideration.

US-CHINA RELATIONSHIP

Economic competition between the US and China is here to stay, with the Biden administration taking a wide-reaching approach to its "competition, not conflict" China agenda. Bilateral relations deteriorated ahead of a long-awaited trip by Secretary of State Anthony Blinken to China following the discovery of a Chinese-operated balloon in US airspace, which was postponed as bilateral tensions increased. The Chinese government additionally ratcheted up its criticism of US tech restrictions, describing the policies as "containment, encirclement, and suppression." These developments point to the US and China entering a period of heightened tensions and an increasingly combative tone in the bilateral relationship, elevating the risk level around potential future flashpoints such as maritime accidents in the Taiwan Strait or South China Sea.

> "China-related legislation has picked up in activity in recent months, serving as one of the few areas of bipartisan compromise in the new Congress..."

Priorities for the Biden administration in its "competition, not conflict" agenda have included export control agreements, industrial policy, and an upcoming screening mechanism for US investments in China. International coordination has been a major theme of the administration's strategy, with the US striking agreements with the Netherlands and Japan respectively for a multilateral export control regime targeting China's access to advanced semiconductor manufacturing technology as a key milestone—which could limit the addressable market and lower revenues for global equipment providers. During the release of the first round of applications for $39 billion in semiconductor manufacturing incentives, the administration further stressed the importance of cooperating with allies as part of a broader vision to make the US into a global leader in semiconductor production and innovation. Recipients of the funding will have to comply with new rules that prevent most forms of investment in China-based semiconductor manufacturing capacity.

On a broader level, a long-awaited outbound investment screening mechanism is expected to be released in the coming months, which would regulate certain outflows of US investment into China. Regulating outbound investment in this manner is uncharted waters for the US and would introduce a level of uncertainty to cross-border capital flows; Congress is working on parallel legislation to clarify the details of the review.

In Congress, China-related legislation has picked up in activity in recent months, serving as one of the few areas of bipartisan compromise in the new Congress; however, differences in priorities and implementation may slow the progress of bills. TikTok has been in the spotlight as a core focus for China-related legislation, with a flurry of bills being filed since the new Congress began in January—including a House Foreign Affairs bill that passed out of committee on party lines and newly-introduced Senate legislation with backing from the White House. Impacts are likelier to be seen in the longer term rather than immediately, but the momentum highlights the increasingly critical stance that Capitol Hill is taking on Chinese tech—and the potential secondary impacts for the technology sector at large.

KEY TAKEAWAYS:

- Geopolitical risks are on the rise and becoming a more prominent part of the macro investment decision-making process.
- Oil, natural gas, and energy infrastructure are likely to see persistent policy impacts as the availability and expansion of these economic inputs is more acutely seen as a core national security interest.
- A lesson learned from Russia's invasion of Ukraine is that the threat of severe economic sanctions is not sufficient as a means of deterrence, which will place renewed emphasis on military power as a critical national security consideration.
- Economic competition between the US and China is here to stay.

Debt Ceiling Primer

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

UK Editors Notes: Whilst optically of interest largely to US readers, the article makes clear that this is a subject of considerable significance to investors in financial markets more widely. If history is a guide the matter should be resolved, albeit perhaps at the 11th hour. The experience of 2011, to which the writer makes reference, illustrates the extent to which international markets were unable fully to divorce from the drama unfolding on Capitol Hill and provides a salutary reminder of the necessity to reach a satisfactory conclusion.

The debt ceiling is back in the spotlight after the US government hit its statutory borrowing limit earlier this year. While there are steps the government can take to continue paying its obligations, these measures only extend for a limited amount of time. Unless policymakers can agree to raise, suspend, or eliminate the debt limit soon, the government could run out of cash to pay its bills as early as this summer. Failure to reach an agreement would have serious economic consequences, including the risk that the US government defaults on its debt. The stakes are high, and it appears likely that a deeply divided government is headed for another debt-ceiling showdown. Divided governments have typically been good for the markets; however, they often spell trouble when it comes to negotiating fiscal matters.

INTRO TO GOVERNMENT FINANCES

Everyone has bills to pay, and that includes the federal government. The government collects revenue through a variety of taxes and uses the funds to pay for everything ranging from Social Security, healthcare, military spending, education and other priorities established by Congress. When the government collects enough revenue to cover its spending, it runs a budget surplus. Conversely, when it does not collect enough revenue to cover its spending obligations, it runs a budget deficit. For the last two decades, the US government has been running a budget deficit. In fiscal year 2022, the government spent ~$1.4 trillion more than it collected. The Treasury Department is authorised to cover the budgetary shortfall by issuing new debt. The cumulative amount of money the government has borrowed over time is referred to as the national debt. The US national debt has exploded over the last 20 years, rising from $6.4 trillion in 2003 to $31.4 trillion today.

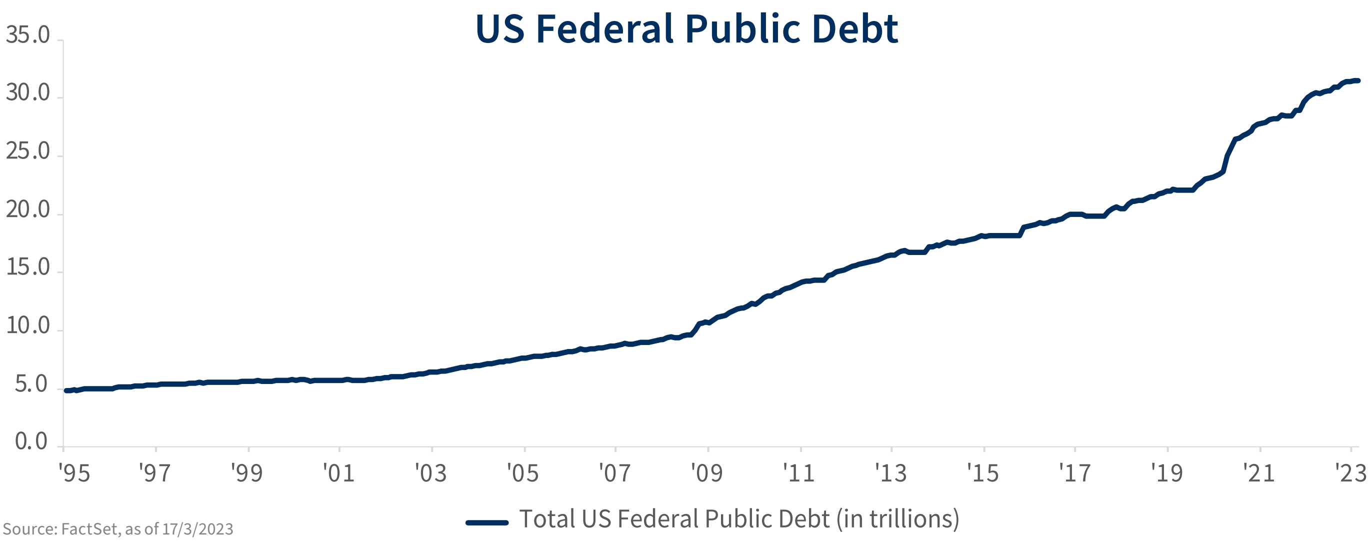
WHAT IS THE DEBT CEILING?

The origins of the debt ceiling can be traced back to 1917 when the US was in the midst of World War I. The new law was initially created to simplify the process of issuing debt to fund war operations. In 1939, Congress established an aggregate debt limit, which has been routinely increased or suspended over the years. Since the 1960s the debt ceiling has been raised 78 times. The purpose of the debt ceiling is to establish a maximum amount of debt the US government can have outstanding. Once the limit has been hit, the federal government cannot increase the amount of outstanding debt until Congress authorises a new debt limit or suspends it for a period of time. Adjusting the debt ceiling has historically been a routine matter that did not garner much media attention or rattle the markets; however, in recent years it has turned into a political hot button. The most notable confrontation, which pushed the US close to the brink of default, occurred in 2011. Past debt-limit showdowns have typically occurred when there is a Democrat in the White House and Republicans have control of Congress.

WHAT'S BEHIND THE CURRENT IMPASSE?

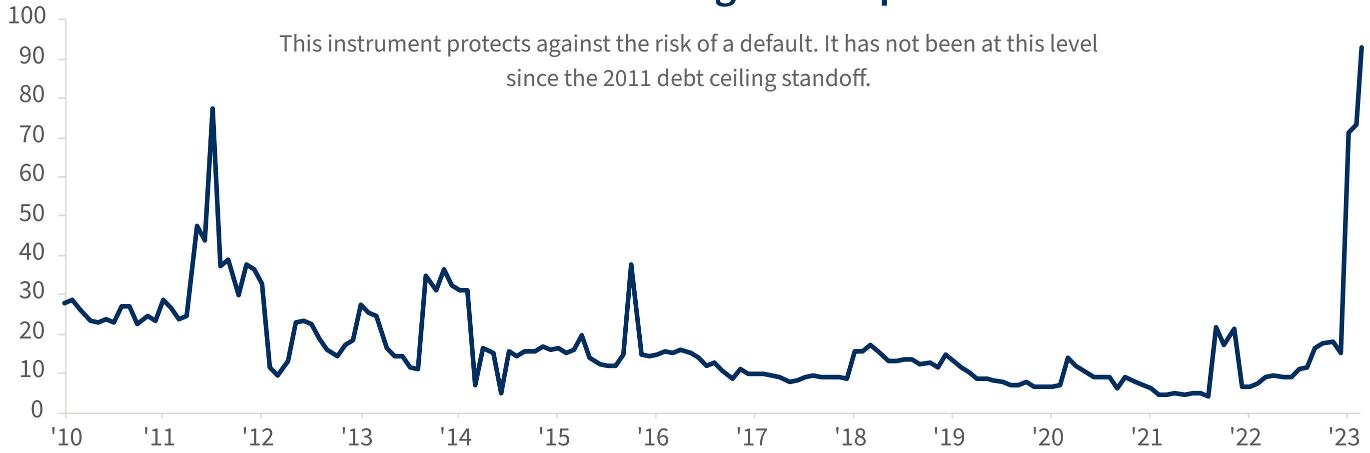
The US government is on an unsustainable fiscal path, with debt and spending growing at an alarming pace. With the huge inflation spike the US experienced last year, fiscal discipline is back on the radar again. House Republicans have made it clear that they intend to push the current administration for budget concessions in exchange for raising the debt limit. Warnings from Treasury Secretary Janet Yellen, Federal Reserve Chair Jerome Powell and other high-profile economists about the potential consequences of not raising the debt limit have thus far been ignored. The White House refuses to negotiate as it wants to pass a clean debt limit increase—that is, not tying an increase in the debt limit to the current budgetary process. This is a key point as raising the debt limit is not about new spending, but rather a legislative procedure that allows the government to finance past spending that has now come due. With neither party showing a willingness to negotiate or budge from their positions, it appears likely that the US is heading for another showdown in the months ahead. This is important because as the country gets closer to the 'x' date—the date the US government would officially run out of money—the closer the US gets to defaulting. If this were to happen, it would send shockwaves through the financial markets.

> The debt limit is not about new spending, but rather a legislative procedure that allows the government to finance past spending that has now come due.



Source: FactSet, as of 17/3/2023

US 1-Year Sovereign CDS Spread



Source: FactSet, as of 17/3/2023

POTENTIAL CONSEQUENCES FOR NOT RAISING THE DEBT CEILING

The US government has never defaulted on its debt; however, the market is getting increasingly concerned about the possibility. This is most evident by looking at the US 1-year Sovereign Credit Default Swap Rate (CDS), which protects against the risk of a default. It has spiked to a level last seen in the 2011 debt ceiling standoff. In 2011, the political battle pushed the US the closest it has ever been to defaulting on its debt. The uncertainty created by the political brinkmanship sent the financial markets into a tailspin. With no agreement in place and the calendar getting very close to that 'x' date, US equities plunged nearly 15% in just a matter of weeks. The uncertainty spilled over to the international equities markets, which fell nearly 30% while the drama was unfolding in the US. The dysfunction in Washington also led to a downgrade in the US' sovereign debt rating. The market volatility was a key factor that drove the political parties to the table to forge an agreement.

Only time will tell if history is going to repeat itself, but the stakes are high leading into this year's debt negotiations. The rating agencies have warned that a default would be a catastrophic blow to the US economy, raising borrowing costs across the board and negatively impacting the broader asset classes. And, with US Treasury debt considered the world's benchmark safe asset, uncertainty about the 'full faith and credit' of the US government would have significant spill-overs into the international markets.

CONCLUSION

We have been down this road many times before and if history is any guide, lawmakers will eventually strike a deal and raise the debt ceiling. There really isn't another option, unless there is political will to repeal the debt ceiling law that was established in 1917.

Given the deep political divides, it appears the US might follow a similar track to 2011, where a debt limit agreement is reached, but at the last possible moment. Since we are still a few months away from the "x" date, the impact on the financial markets has so far been limited. But, as we draw closer to the "x" date, market turbulence may pick up. However, past experience indicates it will likely be short-lived.

> If history is any guide, lawmakers will eventually strike a deal and raise the debt ceiling. There really isn't another option...

KEY TAKEAWAYS:

- The US government has hit its statutory borrowing limit.
- The debt limit is not about new spending, but rather a legislative procedure that allows the government to finance past spending that has now come due.
- Failure to reach agreement on the debt limit has serious, potentially catastrophic consequences for the financial markets.
- We expect that in the end, lawmakers will strike a deal and raise the debt ceiling; however, they will likely wait until the last possible moment.

Everything Everywhere All At Once; Banking Turmoil and its Aftereffects

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

It was April, not March, that the poet and playwright TS Eliot once described as "the cruellest month", yet the latest verse in this strangest of years has proved the most volatile for investors in financial markets. Without question, the month of March has been dominated by concerns regarding the health of the banking sector and possible contagion elsewhere. Whilst those with responsibility for market oversight have acted in both a swift and timely fashion to ringfence mid-month turmoil, restoring order to what threatened at one time to descend into disorderly chaos, the ramifications both for the global economy and financial assets will likely take a while to play out and form a critical feature on investing landscape for some considerable time.

A discussion regarding the March tumult visited on both sovereign bonds and stock markets should start with applause for regulatory oversight. The failure of the US regional Silicon Valley, Silvergate and Signature banks has, as Senatorial testimony confirms, little to do with regulation and its process. The reasons why capital adequacy fell below those statutory minimums set out in Basle IV rules remain the subject of conjecture, but regulators moved fast to close these businesses down before Tier 1 capital (retained earnings and shareholder equity) could turn negative. True, some depositor flight did take place, funds finding their way into the money markets, other larger banks and the bond markets, but it could have been much worse. For all the furore surrounding depositor insurance (a debate which has surfaced tangentially in the UK and Europe too), the failed US regionals have sufficient assets to pay out all remaining depositors without recourse to taxpayer funding. To be clear, a crisis is an adverse circumstance in which there are no good policy options, only choices between bad and less bad. Although financial markets have been rocked by unfolding events, having prepared the ground for possible future problems in the immediate aftermath of the Great Financial Crisis of 2008/09 good policy options do now exist, and they have been deployed with alacrity. Closing down and liquidating those banks immediately when Tier 1 capital drops below 6% of risk-weighted assets (raised

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from 4% as recently as 1 January) may feel radical, but it is the right option when public confidence is to be retained and contagion avoided. Acting pre-emptively is key and is how Swiss authorities have handled Credit Suisse' folding into UBS too.

It is no surprise that financial markets reacted as they did, suffering a barely suppressible fear that just because three US banks failed and one, admittedly large, Swiss bank faltered must mean that other banks must follow. However, such fevered speculation has no rational basis. A commercial bank is in key respects a unique institution. At heart they are companies like every other, with a fiduciary duty to shareholders to generate profits. In banking, making a profit involves taking risks and risky undertakings do not always generate good results, especially when developed economy central banks around the world are raising interest rates as aggressively as they have over the past year or more. But banks differ from other commercial entities in that they have an equally important fiduciary responsibility to depositors, who hand over their money in good faith in anticipation that it will be invested by the bank in safe loans. In this sense, banks are also public utilities; depositors have done, and are doing, nothing wrong in holding their money in bank accounts.

The only surprise in all this, is that markets were as surprised as they were. When central banks embark upon a process of monetary policy tightening as quickly and as aggressively as has been the case something, somewhere was almost bound to happen. Bank of England Monetary Policy Committee member Dr Catherine Mann was not alone when recently expressing surprise by the economy's apparent resilience and capacity to withstand higher interest rates, but at some point, a point now clearly reached, the effects would inevitably start to show up in the most interest rate sensitive sectors of the economy, especially those whose business models operate at the interface between monetary policy and the real economy. Banks are, in the end, businesses that are hugely sensitive to changes in interest rates and especially to government bond yield curves that have been deeply inverted for some considerable time.

Where all the above affects the broader economy, and financial markets by extension, is that any bank facing uncertainty over its depositor base, or building in tighter lending standards, will very likely act to withdraw credit from the economy. Indeed, the latest Bank of England data on bank lending reveals that in the UK this is a process underway since last August. Real bank lending is also on a declining trend in Europe and Canada too. It will likely not be too long, think rapidly repricing financial markets, before banks even more generally must be forced to reel in credit to preserve capital adequacy. A situation in which even well capitalised strong banks stop lending, a so-called "Minsky moment" after the theory posited by economist Hyman Minsky was, ironically, just what the world's largest central banks aimed to achieve at the outset of the rate hiking process. That it has taken so long for cracks to emerge has much to do with the fact that consumer cash balances were, initially at least, replete with pandemic relief cash, while wildly over-reserved banks were insulated from the initial effects of central bank balance sheet run-off, otherwise known as quantitative tightening. With these buffers diminishing, tighter lending standards will likely throttle economic activity, exactly what central banks wanted at the outset of the rate hiking process.

So now financial market pricing is in the process of adjusting to the likely imminent onset of recession. Stock markets have, perhaps counterintuitively, rebounded as March (and the calendar quarter) has come to an end and investors are grateful to the Federal Reserve and its systemic central banking counterparts for the emergency provision of ample liquidity and on a daily, not weekly basis as was the case before the episode's onset. But the main tool in a central banker's tool kit is the interest rate. Having previously priced to anticipate a prolonged pause period once the end of the rate hiking process has been signalled, financial markets are adjusting to the possibility that that pause period might be sharply foreshortened before rates are cut as recessions are confirmed and inflationary pressures finally quelled. As TS Eliot wrote, *"April is the cruellest month, breeding lilacs out of the dead land, mixing memory and desire, stirring dull roots with spring rain".* As every good gardener knows, the lilac symbolises renewal, stirring feelings of hope at the last dissolving of winter's snowy shroud. There may be more alarms and excursions before finally this book of verse concludes, but markets are at least shifting onto more familiar ground.

KEY TAKEAWAYS:

- Regulators and those with responsibility for financial market oversight have acted swiftly to ringfence turmoil in the banking system and restore order to financial markets.
- Residual concerns regarding the consequences of rapid monetary policy tightening remain, but depositor balances in commercial banks are secure.
- Financial markets are adjusting to a seemingly inevitable tightening in credit availability and its likely impact on economic activity.
- The counterpoint to economic weakness will be a more subdued inflation environment and lower interest rates, perhaps sooner than had otherwise been envisaged.

Inheritance Tax Planning

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

The government collected £6.1bn in Inheritance Tax (IHT) bills for the 2021-2022 financial year – a 14% increase on the year before. With the banding frozen until 2028 following the 2022 Autumn budget, this will only continue to move upwards.

According to the Office for Budget Responsibility, the tax revenues will rise to £8.3bn by 2026.

The Chancellor, Jeremy Hunt, announced that IHT, which is charged at 40% of a person's estate above the tax-free allowance (also known as the nil-rate band) of £325,000, will be frozen until 2028. This had already been frozen until April 2026 by Rishi Sunak when he was Chancellor. It is now nearly fourteen years since there was a change to the core IHT allowance, having remained at the same level since 2009.

The Residence Nil Rate Band (RNRB) of £175,000 may be available (in addition to the NRB) if you are passing your main residence to a direct descendent, such as a child or grandchild. The RNRB is reduced on estates worth over £2million and tapers by £1 for every £2 of value by which an estate exceeds the taper threshold. If the RNRB has not been fully used on the estate of the first to die of a married couple or civil partnership the unused part can be transferred to the second estate.

BELOW ARE SEVEN WAYS THAT CAN HELP YOU MINIMISE YOUR INHERITANCE TAX BILL

Around one in twenty-five deaths results in an IHT liability, according to pension provider AJ Bell. Early planning can help reduce or remove this potential tax charged at 40%.

Please note these are simplified examples of what can be done and if they are of interest, you are best advised to seek professional advice.

MAKE A WILL

Start by making a Will. If an individual passes away without a valid Will, their estate will be distributed following a specific set of guidelines which could in turn generate more of an Inheritance Tax liability, leaving less of the estate to loved ones.

TAKE ADVANTAGE OF GIFT ALLOWANCES

This can be the easiest way to pass your assets onto your loved ones without paying tax. But there are some things to consider.

There is no Inheritance Tax to pay on gifts between spouses or civil partners. You can give them as much as you like during your lifetime if they:

- live in the UK permanently
- are legally married or in a civil partnership with you

There is also no Inheritance Tax to pay on any gifts you give to political parties.

Anyone can give up to £3,000 of their assets or cash each tax year without the amount becoming liable for IHT, no matter when they die. If unused, it may be backdated one year to total £6,000.

Gifts of £5,000 to children made in advance of a wedding are also protected from IHT; for Grandchildren this amount is lower at £2,500.

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This may be on top of your annual £3,000 exemption. You can also make unlimited wedding gifts of £1,000 to any non-related person each tax year.

But, if you die within seven years of making a gift in excess of your nil-rate band of £325,000, IHT will be payable on a sliding scale as shown below:

Time between making the gift and death	Tax applied to the gift
0 - 3 years	40%
3 - 4 years	32%
4 - 5 years	24%
5 - 6 years	16%
6 - 7 years	8%
7 years	0%

Source: https://www.gov.uk/inheritance-tax/gifts

Another option is for a gift to be exempt as a gift out of surplus income, however the following conditions must be satisfied:

- The gift must be part of your normal (i.e typical or habitual) expenditure; and
- The gift must be made out of your after tax income taking one year with another; and
- After allowing for all other transfers of value forming part of your expenditure, you are left with sufficient income, in order to maintain your usual standard of living.

In order to satisfy that the gifts were part of your normal expenditure, it will be necessary to show a commitment to make regular gifts as part of a settled pattern of giving.

PUT IT IN A PENSION

The main purpose of a pension is to provide you with income in retirement. But you can also nominate beneficiaries should you pass away before you receive it. The nominations must be submitted directly to your pension provider, and generally IHT is not payable.

If you die after the age of seventyfive your beneficiaries will need to pay income tax on the money they take out of the pension. The rate depends on whether they are a basic (20%), higher (40%), or additional rate (45%) taxpayer.

INVEST IN AIM (ALTERNATIVE INVESTMENT MARKET) SHARES

AIM is a sub-market of the London Stock Exchange which allows investors access to smaller companies.

Investing in qualifying AIM shares have IHT benefits, since many stocks on London's junior stock market can qualify for Business Relief. However not all AIM shares qualify (as approved by HMRC) and you must hold the shares for at least two years to be exempt from IHT. They also need to continue to be qualifying upon death. AIM companies are smaller, less established companies and share prices can be volatile.

The UK Government's decision in 2013 to allow AIM-listed shares to be held within Individual Savings Accounts (ISAs) means that investors can now hold BR-qualifying shares within a tax-efficient ISA wrapper.

SET UP A TRUST

Setting up a trust to hold your assets could be another option to consider.

The trustees control the assets, rather than them being passed onto the beneficiaries right away. This may be useful if you are concerned about gifting assets to a loved one who is perhaps not renowned for their financial prudence, or perhaps to minors.

Important to note that trusts can be expensive to run and subject to tax charges, which together with their complexity makes them worthwhile in only a few circumstances.

TAKE OUT AN INSURANCE POLICY

You may purchase an insurance policy that covers IHT liability, these are generally written in trust.

This route offers you peace of mind, that your beneficiaries will not struggle with a huge Inheritance Tax bill when you die. You are effectively paying at least part of that bill while you are alive through your monthly premiums, which can sometimes be substantial. As you might expect, the older you get the higher the premium. Though this will vary depending on your underlying health.

DONATE TO CHARITY

If you leave any part of your estate to charity you receive a proportionate deduction on your IHT rate.

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International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility. Investing in emerging and frontier markets can be riskier than investing in well-established foreign markets.

Investing in small- and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.

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.

If bonds are sold prior to maturity, the proceeds may be more or less than original cost. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

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.

High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of your portfolio.

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

The process of rebalancing may result in tax consequences.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. Investors should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

The 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.

The indexes mentioned are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market.

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. The JP Morgan Emerging Market Bond Index tracks U.S. dollar denominated Brady bonds, loans and Eurobonds.

END NOTES

Labour Force Participation: Where Did the Workers Go?

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