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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

Markets: *Mild* or *Spicy*?

Lights, camera, cook! On *Top Chef*, one of America's most popular kitchen competition television shows, contestants walk in with knowledge and experience—but no idea what challenges they are about to face. Their goal: to prepare a *dish* that pleases the expert chefs judging them. But the judges toss in a mix of ingredients that no contestant would expect. The aspiring chefs have to think on their feet, improvise and beat the clock.

Sound familiar? Not only was fast footwork the investment story in 2023, the competition is set to get stiffer in 2024. Here are our ten themes for the upcoming year—our basic menu. Count on more than a few surprise ingredients throughout the year to *spice* up the financial markets! Let's head into the kitchen and see what's cooking as we enter 2024.

1 US Economy: 'Rotisserie' Cycles

The most talked about recession in history has yet to materialize. Many economists have stopped waiting for the delivery and have revised the menu. We still believe that a recession will start in 2Q, but it will likely be the mildest ever. Indeed, it may be so mild that markets barely notice it—just a morsel to whet the appetite for the recovery to follow. We expect the recession to be mild because there are no excesses in the economy, and like a *rotisserie oven*, many parts of the economy have been rotating from hot to cold independently over the last few years. Case in point: in 2023, travel and leisure were *toasty* while housing *cooled*. This rotation reduces the potential for all components of the economy becoming *chilled* at once—the usual recipe for a more severe recession. Even with a mild recession, a recovery by year end should help US GDP warm to a ~1% growth rate for the entire year.

2 Monetary Policy: Chairman Powell, The Top Chef

The Federal Reserve (Fed) is led by our favorite Top Chef: Jerome Powell. Under pressure to cool inflation, he served up a steady course of interest rate hikes over the last eighteen months and whipped inflation from 9% to 3.1% currently. Since that restrictive diet is done, the Fed will turn its attention to fattening the economy as growth concerns mount (i.e., a modest rise in unemployment and a potential recession). Markets are *salivating* over the possibility of as many as six interest rate cuts in 2024, but we believe that is overly optimistic; we favor three or four. More rate cuts than that would likely mean the economy is struggling more than we anticipate.

> “We still believe that a recession will start in the second quarter of 2024, but it will likely be the mildest ever. Indeed, it may be so mild that markets barely notice it...”

3 Fixed Income: A Makeover ‘Rescue’

Like the guests on *Bar Rescue*, fixed income investors for the last few years may have felt like they were in bad shape, just like the shabby drinking establishments on the show. In both cases, the underlying business and fundamentals are in place and a makeover is all that’s needed. That makeover occurred in the bond market as the sharp reset to higher interest rates gave long-term investors an attractive entry point. What was old is new again. At today’s elevated yields, the traditional role of fixed income—providing income and diversification from equities—has been restored. With a potentially mild recession and rate cuts on the horizon, we forecast the 10-year Treasury yield to fall to 3.5% in 2024. A more challenging macro environment could drive corporate spreads wider, even though absolute yields remain attractive. We favor investment-grade corporates and municipals over the lower-rated segments of the market. As in *Bar Rescue*, location matters.

4 US Equities: The Critical Eye Of Gordon Ramsay

In his show *Hell’s Kitchen*, Gordon Ramsay is often hyper critical of the contestants. Just as he has a discerning eye for cooking, investors will need to be more selective in 2024 with their sector, region, style, and market capitalization choices. That’s because a lot of the good news has already been priced into the market, including expectations for a soft landing, Fed rate cuts and easing inflation. The proof in the pudding is that the P/E multiple is trading near the upper end of its 20-year range. For the equity market to move higher, earnings will have to grow to sustain the upward trajectory. Given our expectation for a mild recession, investors should turn a skeptical eye to a consensus earnings estimate of $245 (+12% EPS growth). We think that is likely too frothy. Our expectation is that earnings growth will be only 2% to $225 for 2024. History (i.e., election years, Fed easing cycle, etc.) suggests our less spicy expectations for the S&P 500—to 4,850 by year end 2024—make more sense.

5 Sectors: New Ideas, Richer Flavors

With a slowing economic environment, earnings growth will be a decisive factor in determining sector performance. That’s why our 2024 *‘Michelin Star’* sectors are like *America’s Test Kitchen*: familiar spaces being improved by experimenting with new gadgets and ingredients. For Technology, valuations remain reasonable despite the strong performance in 2023 because earnings have outpaced price growth since 2021. Growing acceptance of artificial intelligence by investors will transform it from the newest tech ‘gadget’ to an investment staple. Expect attention in the sector to remain healthy and supportive. Speaking of healthy, while Health Care underperformed last year, we see it offering some of the strongest earnings growth of any sector in 2024. That should boost investors’ appetites. Continued investment in innovative drugs and procedures will further turn up the heat. For Industrials, we expect a bottoming in manufacturing activity followed by continued investments as a result of the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act and Inflation Reduction Act. The effort to promote reshoring of critical products should be a catalyst for the sector over the next 12 months.

6 Small-Cap Equities: Don’t Pass Up The ‘Dives’

On *Diners, Drive-Ins and Dives*, Guy Fieri fires up his bright red 1968 Chevy Camaro convertible and goes roaring around America to find great food in unexpected, small, relatively unknown places. While some ‘dive’ restaurants look ugly on the

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

outside, the food and atmosphere on the inside make up for it. Underperforming small-cap equities may appear unappealing at first glance, but fundamentals under the surface make them worth visiting. First, small caps are trading near a record discount relative to large-cap equities. Second, small caps historically outperform large caps coming out of a recession. Third, small caps typically outperform large caps following the first Fed interest rate cut. Fourth, our three favorite sectors (Industrials, Health Care and Info Tech) are three of the four largest sectors in the small cap index. Lastly, small cap's total market capitalization is less than some of the largest individual constituents in the S&P 500, which means that small inflows can have an outsized influence on the pace and magnitude of the rally. Don't drive by without *sampling the menu* and atmosphere.

7 International Equities: US Is 'Grade A'

When looking at the global equity markets, US equities are still our *prime* choice. Developed market international equities are 'sale priced' relative to US equities, but growth headwinds could *spoil* earnings trends in the coming quarters, particularly in Europe. Japanese equities may be an outlier in 2024, underpinned by corporate governance reforms and an ongoing economic recovery. Emerging markets remain a long-term opportunity for investors. They should *ripen* with the end of the Fed tightening cycle, a modest weakening in the dollar and a rebound in economic growth in Asia and Latin America. We continue to see *tasty* opportunities in select emerging markets, particularly in India and Mexico, where the tailwinds from shifting supply chains and friendshoring should continue to provide a *recipe* for growth.

8 Energy: Discipline In The Kitchen

Discipline is important when you're wielding a sharp knife or cooking over an open flame. It's even more important in the energy market *kitchen*. In 2023, OPEC+ was disciplined for controlling oil supply. And private companies—especially smaller ones—exercised careful capital discipline in drilling for additional oil. In general, we believe energy production discipline will continue to limit the growth of the oil supply. Assuming a very mild recession in the US, a robust rebound in countries like India and China and a recovery in the US and Europe later in 2024, the *hunger* for more oil will increase. That, combined with elevated geopolitical risk, leads to upside from current levels. As a result, our 2024 year-end target for oil is $85/barrel, supporting our contrarian call on the Energy sector.

9 Volatility: Turning Up The Heat

Volatility was relatively modest last year from a historical perspective. Why? Because of exceptional pessimism at the beginning of last year. Investors feared a recession, stubborn inflation, imploding corporate earnings and the Russia/Ukraine war. In retrospect, that pessimism was overstated; each of those dynamics had surprisingly more favorable outcomes—at least in the markets' eyes. In 2024, we appear to have the opposite view: uber-optimism leaves the market vulnerable to disappointment. *Chop-licking* expectations are optimistically forecasting a soft landing, six fed rate cuts, double-digit corporate earnings growth, falling energy prices and a continued consumer spending spree. Combine that with a hotly contested US presidential election and nearly 40 other elections around the globe. If you thought the *kitchen* was kind of warm last year, get ready for more volatility in 2024.

10 Asset Allocation: Pace Yourself At The Buffet

How many times have you gone to a buffet and regretted eating too much of one thing and missing out on something you really wanted further down the line? Well, that doesn't happen at the finest restaurants in the world. There, *seven-course* meals are perfectly paired, crafted and proportioned. We want investors to experience well-crafted fare, which is why we place so much attention on building an asset allocation that matches your tastes. We are factoring in a modest upside for most asset classes in 2024, but don't let a so-called 'everything rally' distract you from maintaining a commitment to a well-structured asset allocation. Faced with a big *buffet*, it is tempting to splurge on whatever looks good today, ignoring a balanced,

> “The pessimism of 2023 was overstated; worrying dynamics had surprisingly more favorable outcomes—at least in the markets’ eyes. In 2024, we appear to have the opposite view: uber-optimism leaves the market vulnerable to disappointment.”

more healthy approach. A savvy cook carefully determines which ingredients, spices and proteins pair best together. Asset allocation strategies, for the most part, should be in place long term. They remind me of one of the most famous infomercial taglines of all time—the ‘Set and Forget It’ rotisserie oven. ‘Set it and forget it’ is great advice, particularly in challenging and more volatile markets. Timing is also important: decisive short-term moves can sometimes save a *meal*, but panic-driven actions can ruin it. That’s why, when it comes to a longer-term investment horizon, we prefer to let things marinate.

We look at the future like the mystery basket in *Chopped*—the ingredients inside could be anything. Creative chefs know how to work with what they are given. We encourage you to peek into our kitchen, with our updated views on what’s cooking, throughout the year. World-renowned chef Bobby Flay said: “Cooking is a subject you can never know enough about. There is always something new to discover.” Don’t let uncertainty scare you out of the market—turn to your *sous-chef* (AKA your financial advisor)—for support and guidance when things heat up.

Wishing you a happy, prosperous—and delicious—2024!

Bon appétit,

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

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2024 Economic Outlook: Prepare for Landing

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

Just as pilots assess conditions before landing, Federal Reserve (Fed) Chair Jerome Powell analyzes the US economy as we enter the final leg of the post-COVID-19 journey. Meanwhile, as investors fasten their seatbelts and hope for a soft landing, we economists fine tune our forecasts for the year. The economy is expected to fluctuate as we expect a wide range of headwinds and tailwinds to challenge the US consumer, but despite some turbulence, we continue to believe that there will be a safe landing.

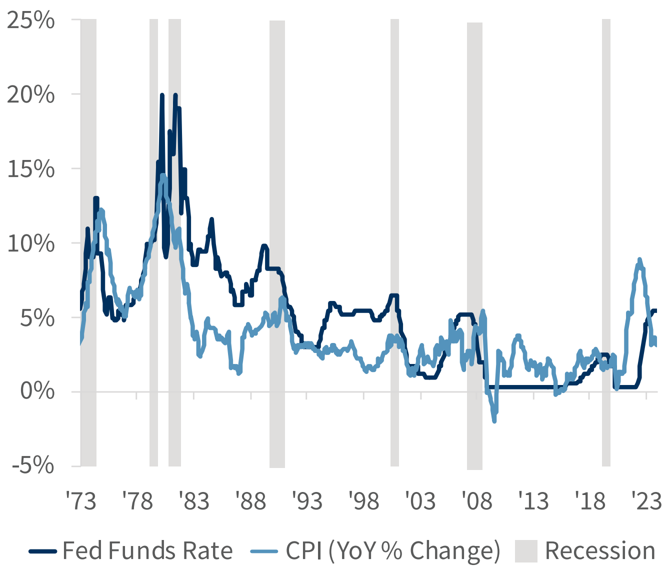
INFLATION: WE HAVE STARTED OUR DESCENT

After more than a year when some analysts argued that structural changes were probably going to keep inflation higher than during the pre-COVID period while preventing the Fed from achieving its inflationary target, inflationary pressures continued to push lower during the third and fourth quarter of last year with no signs that structural changes would be able to prevent the Fed from achieving the 2% inflation target.

The Consumer Price Index (CPI) continued its disinflationary path toward the end of 2023, bringing significant optimism to investors. Hopes of a soft landing and expectations of inflation hitting the 2% target faster than many had expected have pushed markets to believe that the Fed will cut rates several times in 2024, starting in the first quarter. We disagree with the markets because we believe that the Fed is more concerned about a potential reacceleration of inflation, especially if the US economy can avoid a recession and it will be very careful in moving rates lower.

If we assume the economy continues to be strong and experiences a soft landing, what would be the rationale for lower rates if the economy can handle a 5.5% federal funds rate and still grow unabated? In this case, we believe the Fed would be more mindful to preserve the opportunity to ease monetary policy if a future recession requires it. For example, along with quantitative easing, the reason the Fed was able to ease monetary policy in the wake of the COVID-19 pandemic was because it raised the fed funds rate from 0-0.25% in 2015 to 2.25-2.50% in 2019. On the other hand, if rates were already lower in 2020, the Fed would have had less ‘cushion’ to work with.

Inflation and the Fed Funds Rate



Source: RJ Economics, FactSet as of 12/15/2023

Even if the economy goes into a mild recession as we are still expecting, the Fed is going to be reluctant to move interest rates much lower fearing that lower interest rates could push inflation higher again. That is, if the Fed starts lowering interest rates, the credit cycle is going to start again with an increase in lending and then potentially generate much higher increases in home prices, which have the potential to reignite inflation again by the end of 2024. If we add continued geopolitical uncertainty or a successful effort by the OPEC+ cartel to push oil prices much higher on top of this, it will be very difficult to see Fed officials accepting the potential for reacceleration of inflation in exchange for stronger economic growth. This is especially true given home prices are on the rise again and the inflationary effects of the 2023 increases in home prices are going to start making their rounds in 2024.

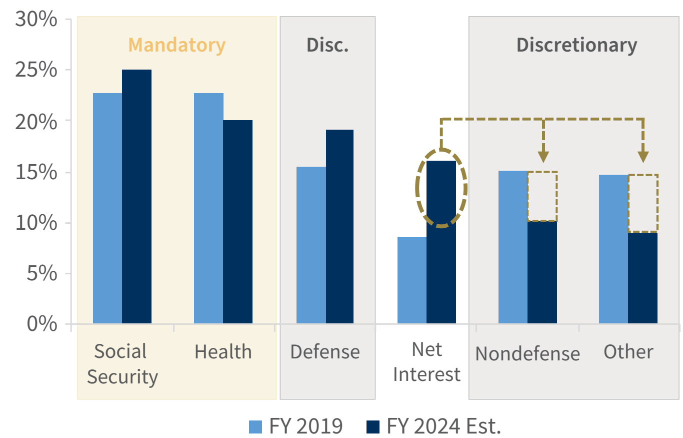
NATIONAL DEBT: SUSTAINED CROSSWINDS

The impact of interest rate increases, amounting to more than 500 basis points since the hiking cycle began, has adversely affected both consumers and the government. The government's annual interest expenditure on the public debt is projected to surpass $1 trillion in 2024, marking the highest figure on record. However, the challenge lies not in the ability of the US to meet its debt obligations; rather, the biggest issue with the US debt is that the political system needs to agree on an already stretched budget to include these interest payments, as well as a long-term solution to the debt problem.

Today, about two-thirds of government expenditures are earmarked for non-discretionary, or mandatory, programs. That is, unless there are changes to current laws, we need to keep paying those expenditures. This is something much like 'fixed costs' in terms of business parlance: there are no degrees of freedom to change those expenditures in the short-to-medium run unless there is agreement between the parties in Congress. The remaining one-third of government expenditures are discretionary, which the US government could potentially adjust to allow for payment of higher interest payments on the debt, but these outlays also require political agreement to decide on a solution.

The University of Pennsylvania's PENN WHARTON Budget Model estimates that the US has approximately twenty years for corrective action under current policies before facing inevitable government default.[1] Nevertheless, there is an urgent need for decisions regarding the US budget to be made promptly despite this projected timeframe.

Composition of US Government Expenditures



Source: RJ Economics, FactSet as of 12/15/2023

> With current available resources, the US is estimated to be able to grow sustainably at ~1.9% without triggering higher prices.

[1]Source: https://budgetmodel.wharton.upenn.edu/issues/2023/10/6/when-does-federal-debt-reach-unsustainable-levels#:~:text=Under%20current%20policy%2C%20the%20United,debt%20monetization%20producing%20significant%20inflation)

LABOR MARKET: TURBULENCE AHEAD

The US labor market added over 2.5 million jobs in 2023, but nonfarm payrolls started to slow during the last few months of the year. Job openings have been on a downward trend since peaking in 2022 and we expect this trend to continue in the first quarter of 2024. As the economy continues to slow, we expect the labor market to contract slightly starting in the second quarter of this year. This should push the unemployment rate higher, to ~4.8% in the third quarter of 2024, but we expect the labor market to start to recover before the year ends.

While layoffs are always painful and costly for individuals as well as for the US economy, we expect them to be much less severe in 2024 than in previous recessions. The average recession experiences ~2.5 million job losses, while we are only forecasting ~1 million jobs lost during the upcoming slowdown. Additionally, the US tax system integrates 'automatic stabilizers,' which provide a natural buffer during an economic slowdown by softening the burden on families through unemployment insurance, income support programs and tax incentives.

THE BOTTOM LINE: CLEARED FOR LANDING

Stable and lower inflation, lower job growth and a weaker consumer are going to slow economic growth from the strong expansion experienced in 2023 to ~1.0% in 2024. While we continue to expect a very mild recession that lasts for two quarters, we want to emphasize that the overall growth for the year will remain positive. With current available resources, the US is estimated to be able to grow sustainably at ~1.9% without triggering higher prices. Therefore, our GDP forecast for the US economy, if it materializes, should not only be welcomed by investors but also by the Fed as inflation will be less likely to reaccelerate.

Additionally, the concept of 'asynchronous recessions' should soften a downturn. That is because several sectors of the economy already experienced a contraction last year. Therefore, as some of last year's expansionary sectors start to weaken, those that contracted in 2023 might start to experience growth. The reason the US economy did not experience a recession in 2023 was because consumer demand, supported by still-strong employment and real income growth as inflation has slowed, has kept the US consumer spending.

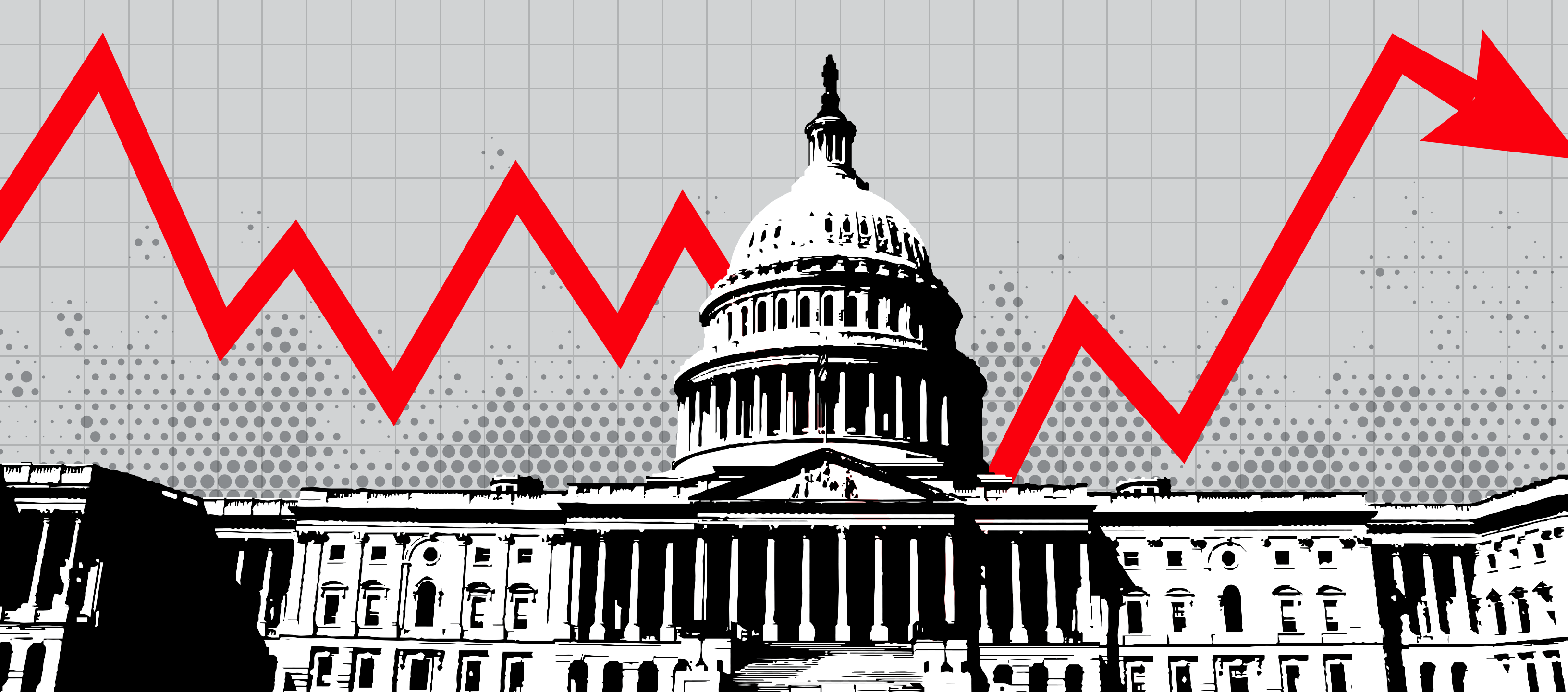
The economic outlook for 2024 should not be the year of 'recession' but rather a year of 'sustained disinflation with weak economic growth.' In fact, according to our forecast, the upcoming recession would not only be very mild, with fewer job losses and declines in fixed investments, but also shorter in duration than the average recession. While we expect consumer spending to weaken, we expect government and nonresidential fixed investment to grow more and provide a cushion to the economic slowdown. This is because government spending tends to increase during a slowdown and fiscal incentives such as the Inflation Reduction Act, the CHIPS Act and the Infrastructure Investment and Jobs Act are likely to continue to incentivize spending despite the high costs of borrowing. The bottom line is that the US economy has been cleared for landing, but in our opinion, it is unlikely to be as soft as many are predicting.

EXPECTED RECESSION VS. HISTORICAL AVERAGES

	FORECAST	AVERAGE
Economic Contraction	-0.3%	-2.5%
Average Duration	6 months	10 months
Jobs Lost	1M	~2.5M
Fixed Investment	-3.2%	-18.5%

KEY TAKEAWAYS:

- Inflationary pressures continued to push lower during the third and fourth quarter of last year with no signs that structural changes would prevent the Fed from achieving its 2% inflation target.
- Markets have begun to believe that the Fed will cut rates several times in 2024, starting in the first quarter. We disagree—we believe that the Fed is more concerned about a potential reacceleration of inflation and it will be very careful in moving rates lower.
- The more than 500 basis points in fed funds rate hikes has negatively impacted both consumers and the government.
- The US does not have an issue with the ability to meet its debt obligations; it has an issue with the willingness to do so which lawmakers must address.
- Stable and lower inflation, lower job growth and a weaker consumer are going to slow economic growth from the strong expansion experienced in 2023 to ~1.0% in 2024.



2024 Preview: Market Performance in a Presidential Election Year

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

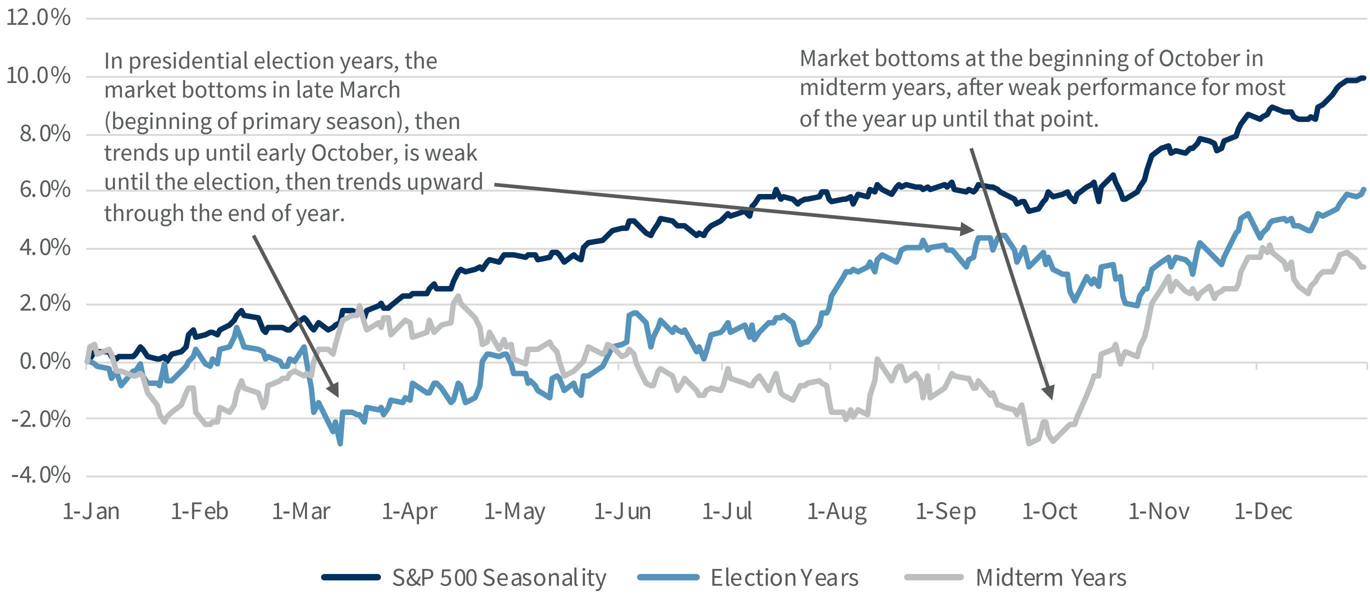
Presidential election years usher in considerable uncertainty. While the most likely scenario remains a rematch of the 2020 election, there seems to be a nagging feeling that something could happen to reset the race and produce an unexpected outcome. This uncertainty, the potential for surprise and the polarized nature of the political environment may cause investors to be cautious in the upcoming election year. Adding to this uncertainty is lingering geopolitical risk, concerns over the trajectory of the debt and deficit, recession risk, and unresolved government funding decisions. From a market perspective, we would not be surprised to see 2024 track traditional presidential election years, where there are pockets of weakness during periods of the greatest uncertainty, but a market rebound and renewed strength as we receive clarity on key issues. In this article, we will provide our outlook for the 2024 elections and provide an update on other key issues that DC will tackle in 2024, with impacts for the US fiscal picture and geopolitical risk.

HOW COULD THE ELECTORAL CALENDAR IMPACT MARKET PERFORMANCE?

The state of play for the 2024 race will remain fluid ahead of Election Day, but a 2020 presidential rematch remains the most likely situation at this stage of the race. However, many unanswered questions remain in the months ahead, with implications for market sentiment at various turning points. Overall, election years have historically seen the second lowest market returns of the presidential term cycle, with an average monthly return of 0.54%. However, markets quickly play catch-up after election year uncertainty is resolved, averaging a monthly return of 1.28% during the year after the election. Midterm election years are the weakest point for markets in a presidential term, historically seeing average monthly returns of 0.3% regardless of the party in control of the White House.

As we enter January, we would highlight to investors that the beginning of election years (January-March) historically sees negative market returns as the primary process—and associated political volatility—hits its peak, with average monthly returns of -0.44%. The primary cycle will kick off on January 15 in Iowa for Republicans and the first ‘official’

S&P 500 Seasonality (Avg. Since 1980) vs. Election & Midterm Years



Source: Bloomberg as of 12/15/2023

primary will be on February 3 in South Carolina for Democrats. Two key measures of strength for an incumbent president are his favorability ratings and the right track/wrong track trajectory of the country. In each of these measures, there are warning signs for President Biden and we will be watching to see if this provides an opening for weaker than expected primary election results for Biden. Biden has two long-shot candidates running against him, but anything less than 75-80% support will set off renewed alarm bells for his campaign.

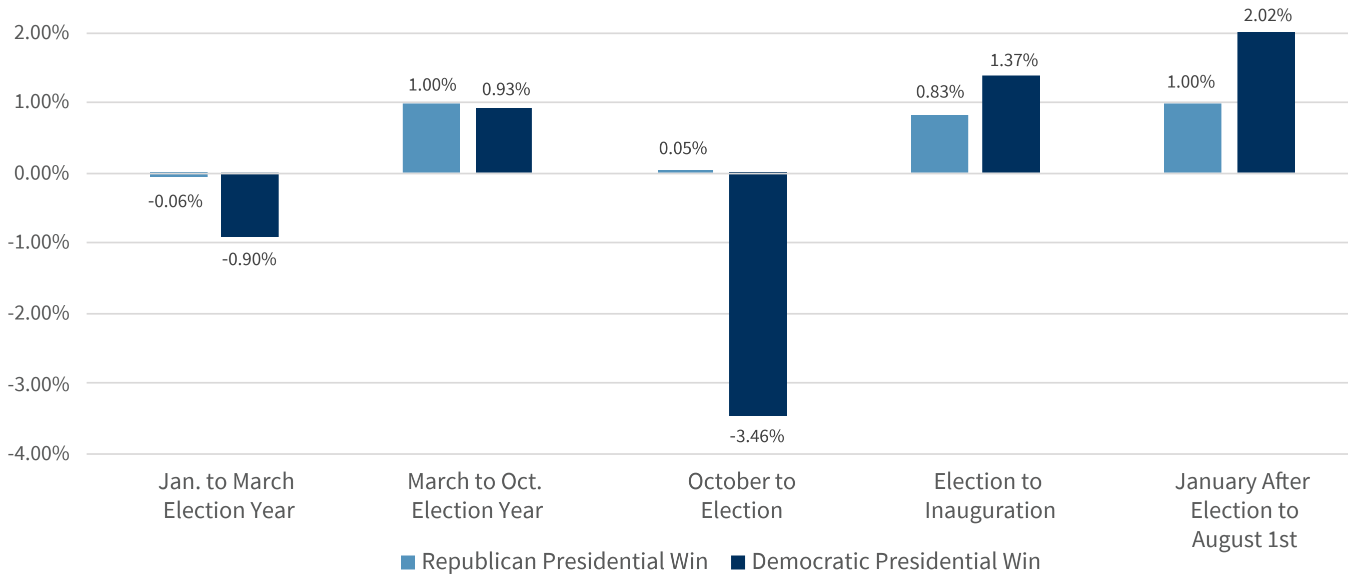
As Republican voters head to the primaries, Trump's continued strong polling numbers suggest his likely nomination to the Republican presidential ticket, but his legal challenges remain a significant wildcard ahead of the primary process. If there is a surprise in the Republican primaries, we would need to see voters coalesce around a clear alternative to former President Trump, picking up momentum in the early states. Should Trump emerge as the Republican nominee, a key debate for the general election will be how much of the election is a referendum on Biden versus Trump, as Trump has similar unfavorable ratings to Biden.

> We would caution investors to avoid using the election as too much of a catalyst for investment decisions.

KEY ELECTORAL INFLECTION POINTS FOR THE MARKET: MARCH, OCTOBER-NOVEMBER

March remains an important inflection point in the electoral calendar, with 34 primary elections, including 16 states holding their primaries on Super Tuesday. The end of the month will provide important clarity on who the prospective nominees might be, with more than half of both parties' delegates awarded ahead of the Republican convention in July and Democratic convention in August. Given this clarity, the period between March and October during an election year historically has seen positive returns (0.97% average monthly returns). Any remaining uncertainty over nominees should be resolved at the nominating conventions—July 15-18 for Republicans and August 19-22 for Democrats. Beyond first quarter volatility, the most significant downside risk is seen in the immediate run up to the election (October through Election Day), with an average monthly return of -1.27%.

Average Monthly Returns With A Republican vs. Democratic Presidential Victory Since 1980



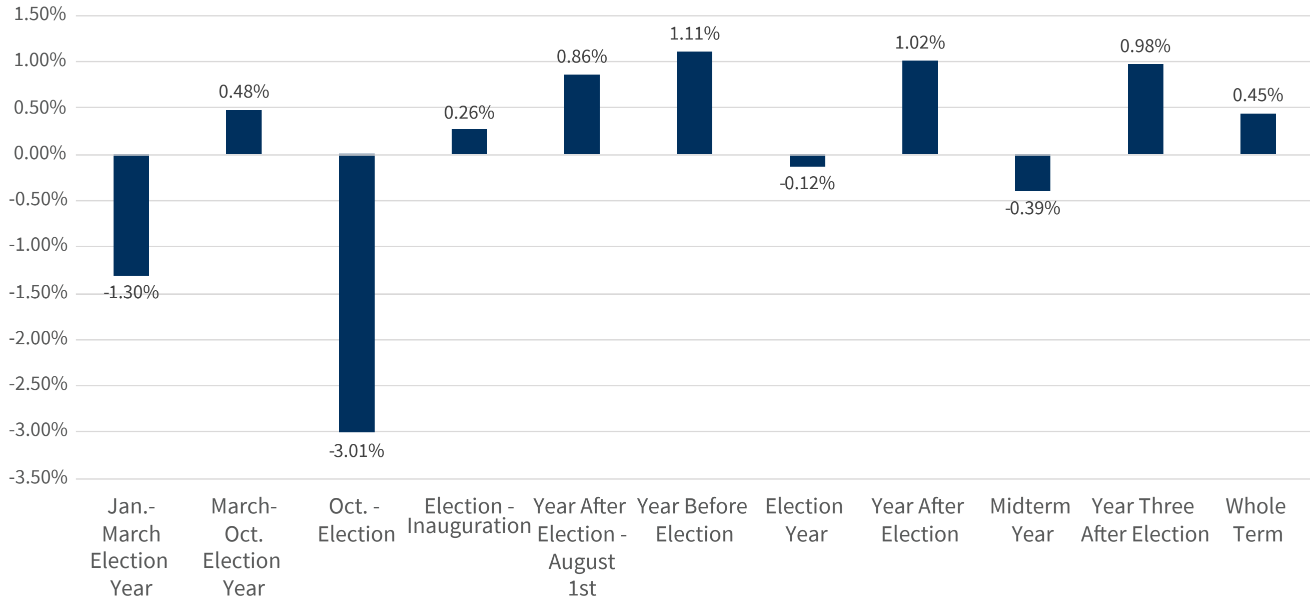
Source: Bloomberg as of 12/15/2023

While the race is likely to remain close until the polls open on November 5, historically we have seen more market weakness in the run up to a Democratic presidential victory versus a Republican presidential victory, but these numbers are a bit skewed by the impact of the global financial crisis in 2008 preceding President Obama's victory. Despite this pre-election volatility, markets tend to quickly play catch-up and see an outsized market return. If Democrats retain the White House, we expect to see a greater positive rotation in the first 100 days of a Democratic presidency compared to a GOP victory— on average, markets rise 1.75% monthly the year following a Democratic presidential win, compared to 0.88% for Republicans. Given this historical correction, we would caution investors to avoid using the election as too much of a catalyst for investment decisions.

Control of the House and Senate will also be up for grabs next November and we would highlight to investors that expectations of a partisan sweep in either direction tend to drive more volatility, seeing -3.01% average monthly returns in the pre-election period. In contrast, expectations of a divided government set the conditions for calmer waters, seeing positive average monthly returns both ahead of the election (0.17%) and in the years after. The race for Congressional control will similarly remain fluid up to election day, but the retirement of Senator Joe Manchin (D-WV) will compound an already challenging map for Senate Democrats, while a slow-to-restart fundraising operation under new House Speaker Mike Johnson (R-LA) could limit the flow of funds to vulnerable House Republicans in key swing districts.

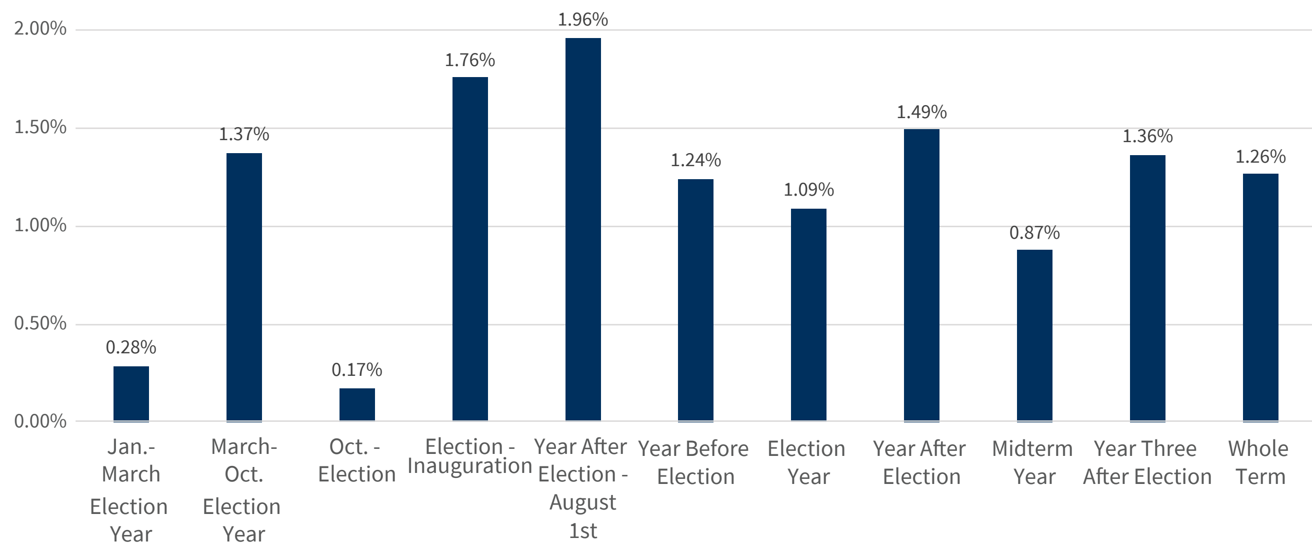
> "Expectations of a divided government set the conditions for calmer waters, seeing positive average monthly returns both ahead of the election (0.17%) and in the years after."

Average Monthly Returns With Republican Or Democratic Sweep Since 1980



Source: Bloomberg as of 12/15/2023

Average Monthly Returns With Split Government Since 1980



Source: Bloomberg as of 12/15/2023

WHAT ELSE DOES DC NEED TO ACHIEVE IN 2024?

Aside from electing a president and a new Congress, DC will enter 2024 with an important to-do list, including government funding and responding to a changing global security environment. A first-mover for investors to watch will be the government funding debate, with new deadlines set for January 19 for four of the twelve appropriations bills and February 2 for the remaining eight bills. Temporary government shutdowns and triggers of 1% across-the-board spending cuts remain possible, which could add to market volatility in the first quarter. While near-term economic concerns have been raised about a potential slump in near-term fiscal support given the spending cut discussions, we would point to the implementation of major infrastructure legislation (including the bipartisan infrastructure law and the Inflation Reduction Act) which will continue to be deployed and have significant macroeconomic impacts.

Geopolitics will be another priority for DC to address throughout 2024, with parallel wars in Ukraine and in Israel/Gaza alongside ongoing Indo-Pacific security concerns likely to shape key legislative, political and regulatory outcomes throughout the year. Amid heightened concerns around fiscal spending and under the leadership of new House Speaker Mike Johnson, additional military aid for Ukraine will continue to come under close scrutiny in the halls of Congress. The pairing of funding for Ukraine and Israel with border security provisions will continue as another first-mover theme once Congress returns. Despite the political process likely slowing down the passage of the supplementary defense funding bill, we continue to expect to see a long-term setup that supports higher defense spending given national security's reemergence as a core legislative and regulatory theme in DC.

Finally, the US/China relationship will also remain in focus in 2024 as DC and Beijing try to restabilize the bilateral relationship through strengthened channels of communication. Reactions to further national security initiatives (such as expanded restrictions on the export of advanced technology) can generate new geopolitical risk for investors to monitor, but will also serve as a test of the new guardrails placed on escalation risk by the renewed bilateral contacts. A hawkish tilt in Congress (compared to the White House) can drive additional market-impactful policy actions out of DC that place further restrictions on China-related economic activities.

Expect to see a long-term setup supporting higher defense spending given national security's reemergence as a core legislative and regulatory theme in DC.

KEY TAKEAWAYS:

- While the most likely scenario remains a rematch of the 2020 election, there seems to be a nagging feeling that something could happen to reset the race and produce an unexpected outcome.
- We would not be surprised to see 2024 track traditional presidential election years, where there are pockets of weakness during periods of the greatest uncertainty, but a market rebound and renewed strength as we receive clarity on key issues.
- The race for Congressional control will remain fluid until election day with Senator Manchin's retirement compounding an already challenging Senate map for the Democrats and slow to restart fundraising operations potentially limiting the flow of funds to vulnerable House Republicans in key swing districts.
- DC will have an important to-do list in 2024, including government funding and responding to a changing global security environment.
- The US/China relationship will also remain a key focus.

Ready, Set, Lock in Rates

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

2023 proved to be another challenging year for the bond markets. Stronger-than-expected growth, concerns about the US government's fiscal outlook and the Fed's pledge to keep interest rates higher for longer drove yields (particularly longer-dated maturities) to levels not seen in decades. After the 10-year Treasury yield climbed above the psychologically important 5.0% level in October 2023, yields headed sharply lower in the final months of the year. While interest rates are well off their recent peaks, yields still stand near their highest levels in nearly 15 years. And with a Fed easing cycle coming into view in 2024, we think yields will trend lower in the months ahead. Although, the journey to lower interest rates is unlikely to proceed in a straight line.

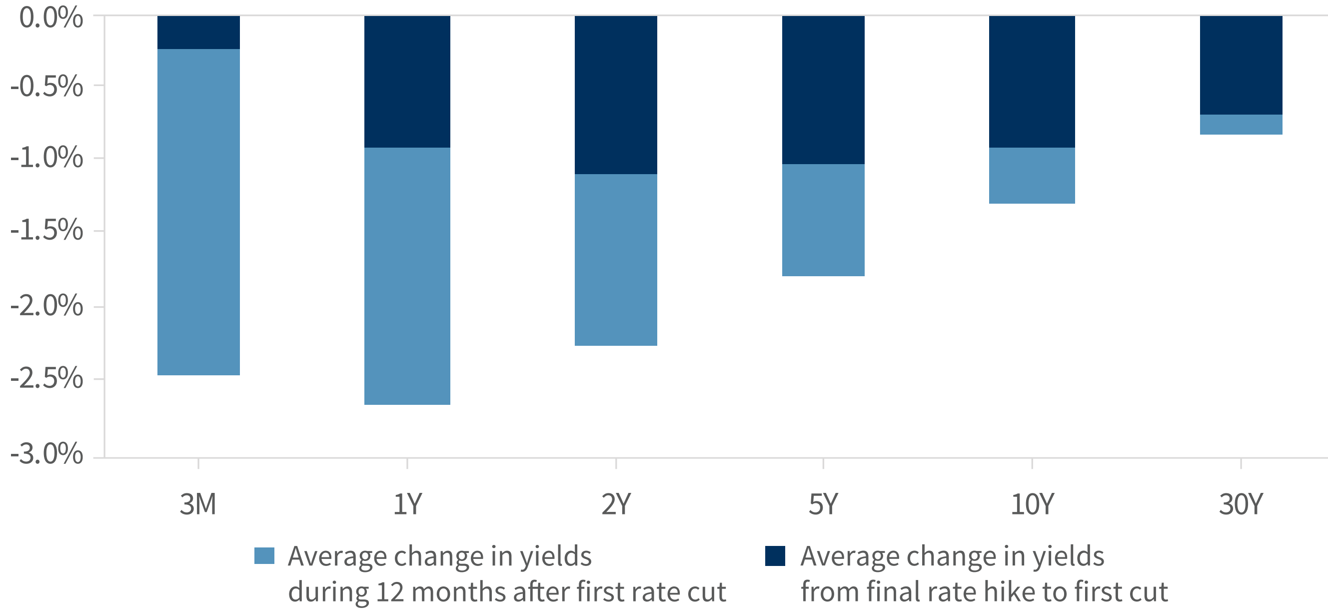
Bonds have historically delivered strong, positive returns when Fed policy is transitioning into an easing cycle. This should be welcome news for fixed income investors who have endured significant volatility and two back to back years of losses. But, as challenging as the last few years have been, there is a silver lining for investors—and that is, the great rate reset has restored yields to more normal levels. And, with yields now at their highest levels in decades, investors can once again reap the benefits of owning bonds. These include an attractive source of income, reasonable yield cushion to offset adverse movements in interest rates or spreads, potential capital appreciation and diversification from equities. These factors were missing when yields were artificially suppressed in the years following the Great Financial Crisis.

> While interest rates are well off their recent peaks, yields still stand at their highest level in nearly 15 years.

MACRO OUTLOOK SUPPORTS OUR CALL FOR LOWER BOND YIELDS

Despite calls for a recession in 2023, the economy remained remarkably resilient. While the long-awaited slowdown has been delayed, we still believe that a recession is coming as the tailwinds that supported growth are fading. Fed policy is restrictive. The long and variable lags of monetary policy are still working their way through the economy and are expected to become a bigger drag on growth as we progress through 2024. The fiscal impulse that supported consumption has ended. Job growth is stalling. And the disinflationary trend that

Yield Changes Leading Into and One Year After First Rate Cut



Source: FactSet as of 12/15/2023

started over a year ago is becoming more entrenched. The bond market has already sniffed out slower growth and sustained disinflation, driving 10-year Treasury yields from a peak of ~5.0% to 3.90%. The market is also pricing in nearly five 25 basis point rate cuts by year-end 2024. While the market may be overly optimistic about what the Fed will deliver in 2024, we do believe that policy rates are headed lower given our expectation for a mild recession next year.

What is up for debate is the pace and magnitude of the Fed's expected rate cuts in the upcoming easing cycle. Policymakers will likely err on the side of caution in lowering interest rates as concerns about a renewed spike in inflation or a re-acceleration in growth could derail their progress to date. However, if a sharper than expected slowdown materializes or inflation decelerates at a more rapid clip (not our base case), Fed officials have plenty of room to lower rates to cushion the downturn. Given the economy's resilience to the Fed's aggressive rate hikes and the unusual nature of this cycle, volatility is likely to remain elevated as the economy normalizes.

Therefore, the tug-of-war between the market's expectation for rates cuts and the Fed's forward guidance is likely to persist. But ultimately, we do believe that the direction for policy rates and Treasury yields will be lower.

BONDS PERFORM WELL LEADING INTO AN EASING CYCLE

Bonds have historically performed well leading into an easing cycle. In fact, once the Fed delivers its final rate hike, yields begin to move lower as the market starts to anticipate the next easing cycle. In the last six cycles, the period between the Fed's last rate hike and the first rate cut (i.e., the 'pause') averaged around seven months. Applying this average to the current cycle suggests that the Fed could kick off its next easing cycle as early as the first quarter of 2024—which coincidentally aligns with the timing of the first rate cut according to the fed funds futures contracts. While caution is warranted when looking at averages, as every cycle is different, it is worth noting that on average, 2-year and 10-year Treasury yields have declined ~100 basis points during the pause period. Yields fell even further once the Fed started cutting rates. More importantly, high quality bonds delivered strong, positive returns after the Fed's tightening cycle ended. We think the next cycle will deliver similar results.

> Given our outlook for slower growth, more disinflation and a Fed pivot in 2024, we believe Treasury yields still have room to move lower.

Cooling inflation pressures, slowing job growth and the end of the Fed's tightening cycle have driven Treasury yields sharply lower in the final months of 2023. The recent decline in 10-year Treasury yields has simply been a retracement of the upside growth surprises and Treasury supply concerns that drove yields higher earlier in the year. In fact, yields are essentially back at the levels that prevailed when the Fed delivered its last rate hike of this cycle (i.e., July 2023). Given our outlook for slower growth, more disinflation and less restrictive Fed policy in 2024, we believe yields still have room to move lower—perhaps not back to the crisis-induced lows reached during the pandemic, but lower than current levels. While the decline in shorter-maturity yields will remain constrained by Fed policy rates, particularly with policymakers reluctant to ease aggressively with inflation still above the 2.0% target, longer maturities will be more responsive to the slowing growth/inflation dynamics. Absent a more aggressive Fed, the yield curve, as represented by the 2-year to 10-year spread, is likely to remain modestly inverted. But over time the yield curve should return to a more normal, positive slope.

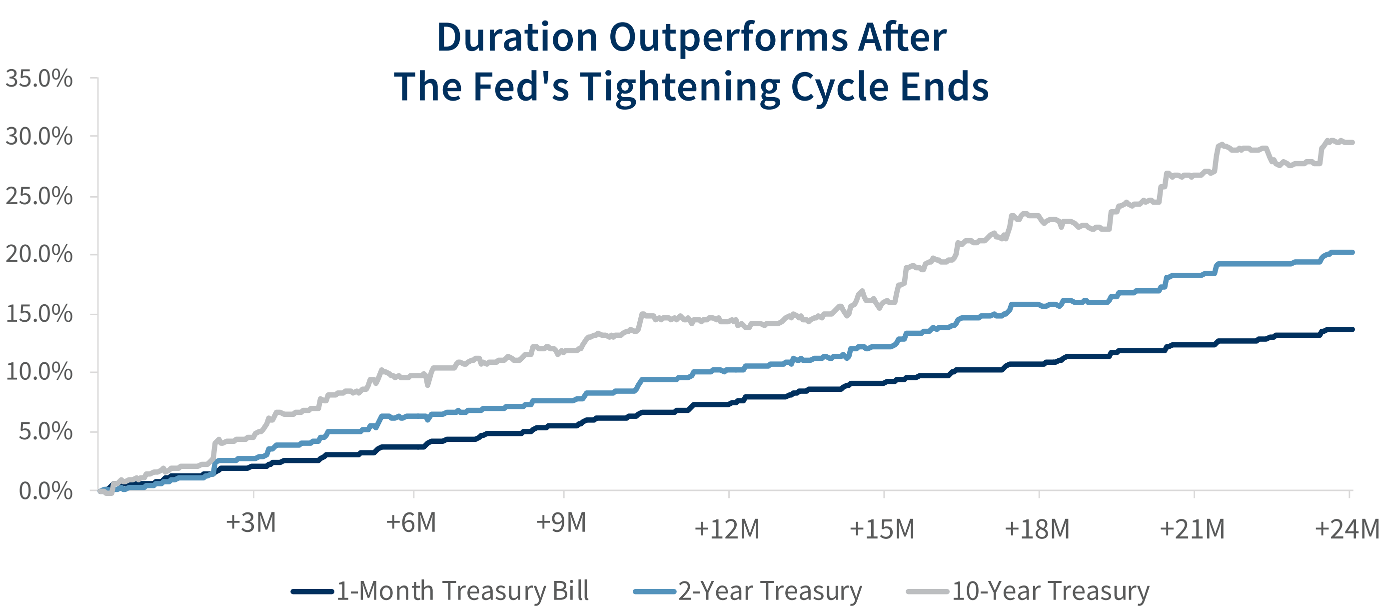
YIELDS HAVE NOT BEEN THIS ATTRACTIVE IN DECADES

The inflation surge following the pandemic has shifted the investment landscape. After a decade or more of extraordinarily low bond yields, interest rates have risen to levels not seen in decades. While the process of getting here has been painful, there is a silver lining for investors—and that is, the income is back in fixed income. This is important because the starting level of yields has historically been one of the best predictors of future returns.

"After a decade or more of extraordinarily low bond yields, interest rates have risen to levels not seen in decades."

And with yields hovering near a 15-year high, bond returns should be much better than they have been in the past.

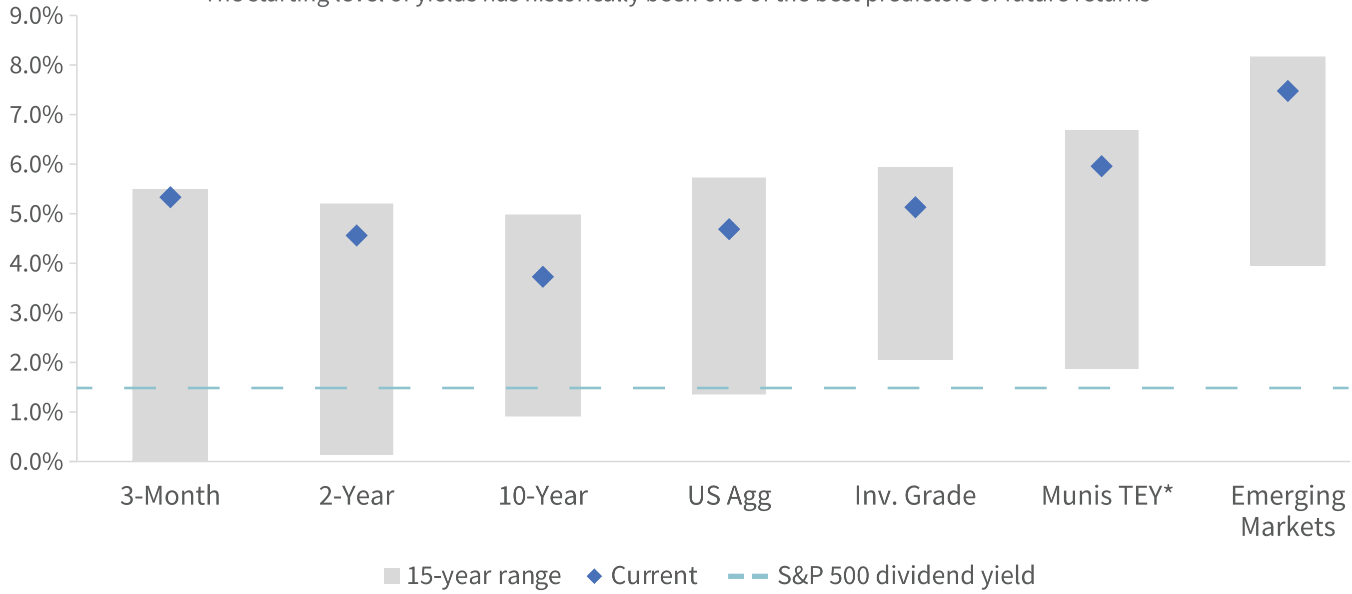
While the majority of a bond's return potential comes from the income component, the opportunity to capture some capital appreciation from a move lower in bond yields is an added bonus for investors. And with a Fed easing cycle coming into focus, we think it would be prudent for investors to consider taking on some additional duration risk and locking in these higher yields while they are still available. This is especially true for investors who have been riding out the storm in cash or cash-equivalents earning competitive yields of 5.0% or higher. While cash yields are attractive today, the allure will quickly fade once the Fed starts cutting rates. In fact, history has shown that cash and cash-equivalents underperform intermediate and longer-maturity bonds by a significant margin after the Fed delivers its last rate hike.



Source: FactSet as of 12/15/2023

Yield Opportunities Across All Fixed Income Sectors

The starting level of yields has historically been one of the best predictors of future returns



Source: FactSet as of 12/15/2023

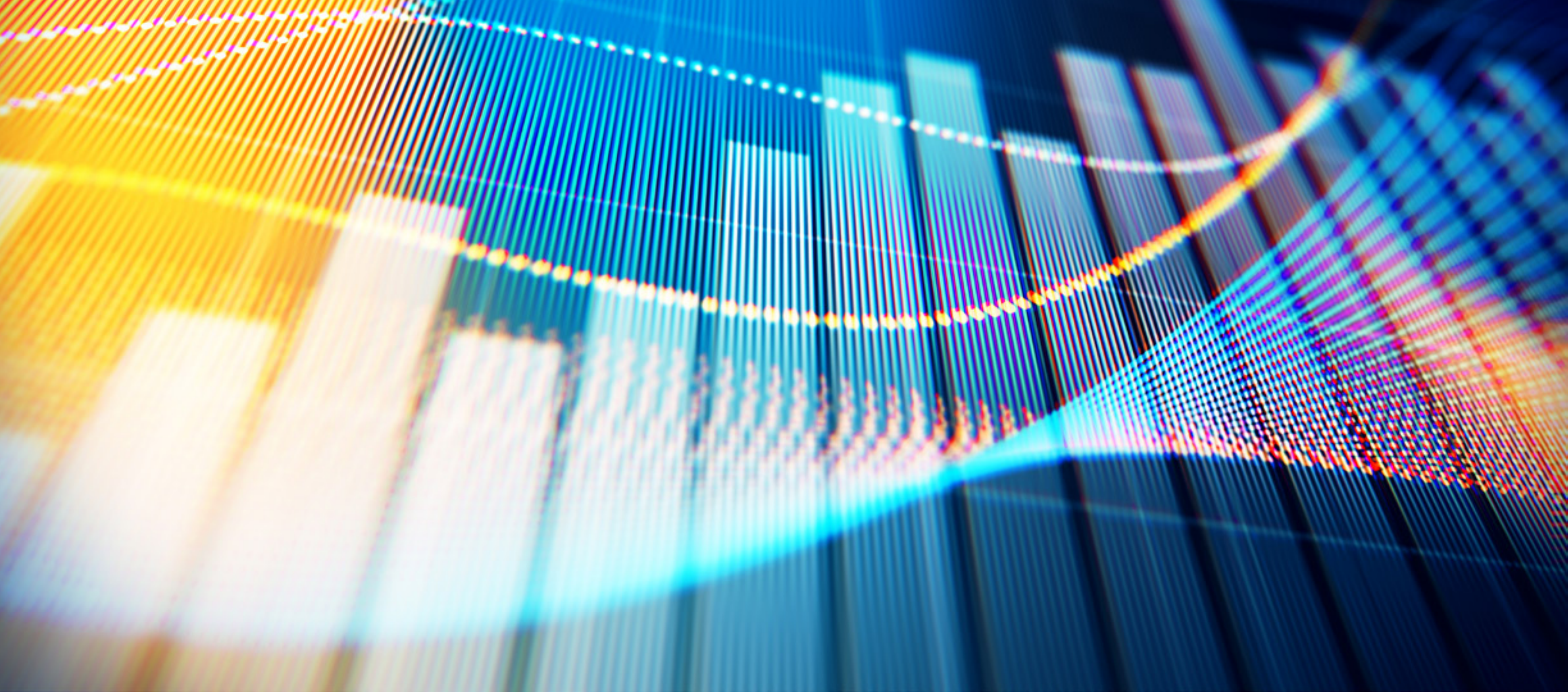
* Tax-Equivalent Yield (TEY) is calculated using a top 40.8% tax bracket.

LOOKING FORWARD

Our optimism about bonds is driven by the high starting level of yields. While this was true in 2023, it is even truer in 2024. With yields across the fixed income spectrum near their highest levels in nearly 15 years, bonds have not looked this attractive on an absolute basis or relative to equities for a long time. Fixed income has the ability to generate mid-single digit returns or greater in 2024. As growth and inflation momentum slows, we look for lower yields and steeper curves in the months ahead. Given our outlook for a mild recession, we favor the higher-quality sectors of the bond market, which include Treasurys, investment-grade corporates and municipal bonds. While high yield bonds offer enticing yields, we remain cautious on the sector given deteriorating fundamentals (i.e., rising defaults, higher bankruptcies, falling interest coverage ratios) and tight credit spreads.

KEY TAKEAWAYS:

- Stronger-than-expected growth, concerns about the US government's fiscal outlook and the Federal Reserve's (Fed) pledge to keep interest rates higher for longer drove yields to levels not seen in decades.
- Bonds now offer an attractive source of income, reasonable yield cushion to offset adverse movements in interest rates or spreads, potential capital appreciation and diversification from equities.
- Bonds have historically performed well leading into an easing cycle.
- We believe that fixed income has the ability to generate mid-single digit returns or greater in 2024.



Respect the Trend But Curb Your Enthusiasm for Stocks Next Year

Talley Léger, *Senior Equity Strategist,* Investment Strategy

US large-capitalization stocks have enjoyed a whopping increase of 23% in 2023 fueled by a Fed policy pause since July, powerful rally in bonds, lower discount rate, softer energy prices, cooler inflation and a weaker US dollar.

After 15%+ annual gains, however, subsequent calendar year returns on the S&P 500 have decelerated 93% of the time, based on records dating back to 1950. Specifically, the median S&P 500 price return in the year after a 15%+ gain was 9%, consistent with the long-term average return of 8% (read: reversion to the mean). Simply put, we don't need a recession to expect a single-digit gain in stocks next year.

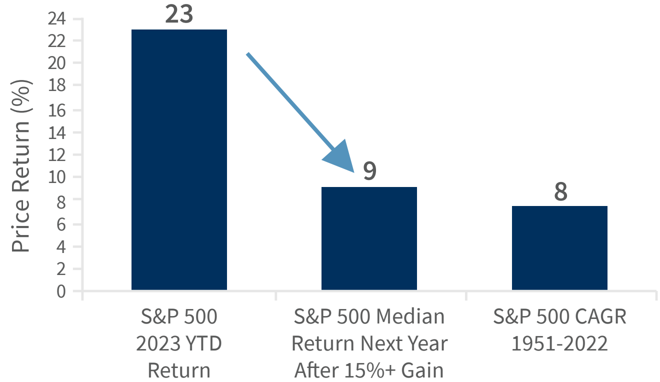
STOCKS ARE OVERBOUGHT AND VULNERABLE TO A PULLBACK IN EARLY 2024

That said, RJ Economics sees a mild recession as the most probable outcome in 2024. The average peak-to-trough decline in stocks heading into recessions has been 30% since the 1950s and we're talking about a mild recession, not the average experience.

From our lens, a recessionary drawdown in the low double-digits—a bit worse than a garden-variety correction—would be a reasonable expectation, meaning the S&P 500 could see the low 4,000s again before ending the year on a positive note.

(Not) Great Expectations

Absent a recession, it's reasonable to expect equity returns to moderate after a 20% year



Source: FactSet, RJ Investment Strategy : YTD = Year to date. CAGR = Compound annual growth rate. As of 12/15/2023

WHAT ARE THE RISKS?

We believe it would require another big increase in energy prices, meaningfully higher bond yields, surging inflation and renewed interest rate hikes from the Fed (all of which seem increasingly unlikely now) to push stocks below their October 2022 lows. Indeed, it appears that we lack the negative forces necessary to recenter outcomes around such an extremely bearish case at this stage.

Consistent with our price target of 4,850 in 2024, a subpar 5-6% advance was the typical outcome for stocks in recessions since the inception of the S&P 500, which usually witnessed an initial selloff before staging a recovery rally. Similarly, the absence of fear amongst investors and proverbial blood in the streets curbs our enthusiasm for equity returns, especially in the first half of next year. However, a growth scare and related risk-shedding event could inject some much-needed panic back into the marketplace, thereby boosting our excitement for stocks later in 2024.

OUTLOOK FOR EARNINGS AND VALUATIONS

In the face of a potential business cycle contraction next year, bottom-up analyst consensus expectations of $243 or 14% year-over-year (YoY) growth for S&P 500 four-quarter operating earnings per share (EPS) seem aggressive to us. That said, a mild yet broad-based recession in 2024 doesn't necessarily mean a catastrophe for the fundamental outlook. Our economists forecast an average annual pace of 4% for nominal gross domestic product (GDP) growth—an intuitive, albeit slowing driver of companies' top lines—which projects a modest 3% YoY growth rate for S&P 500 four-quarter sales per share (SPS) next year. Given the -23% peak-to-trough compression in net profit margins from the fourth quarter of 2021 to the first quarter of 2023—which is in line with the typical recessionary adjustment—as well as ongoing company expense management and hiring discipline, the Investment Strategy Committee assumes a flat margin of 11.6% to arrive at $225 or 2-3% YoY growth for S&P 500 four-quarter operating EPS in 2024.

Meanwhile, the current S&P 500 trailing four-quarter operating price-to-earnings (P/E) ratio of 21.5x is above its long-term average, yet still below +1 standard deviation away from its mean. In other words, US large-cap valuations are elevated, but not unusually so. In our view, ongoing tailwinds in the form of softer oil prices, cooler headline inflation, melting bond yields and enthusiasm about the beginning of Fed interest rate cuts should continue to support a similarly lofty multiple of earnings next year.

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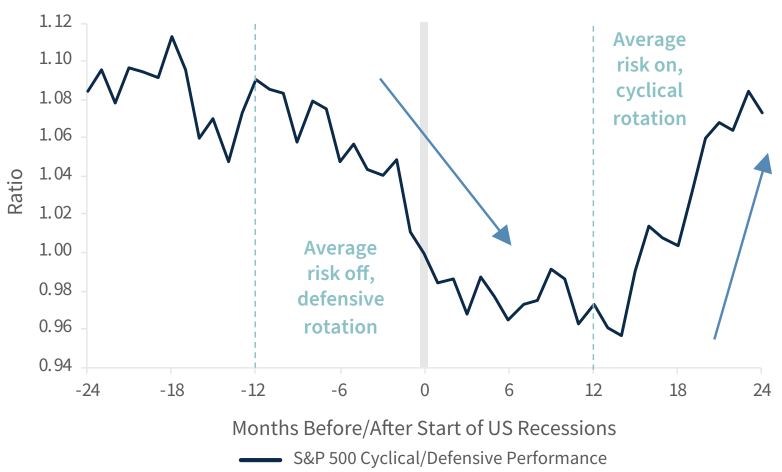
SECTOR, SECTOR ON THE WALL, WHO'S THE FAIREST OF THEM ALL?

We foresee a defensive rotation into the lagging Health Care and Consumer Staples sectors, largely owing to their resilience to the business cycle, valuation discounts and positive earnings outlooks. In a reacceleration or recovery type of scenario, we expect the early-cycle, rate-sensitive Consumer Discretionary sector to continue doing well. Also, the economy-sensitive Financial and Industrial sectors should benefit from the favorable combination of valuation discounts plus positive catalysts in the form of rebounding earnings growth later next year.

First Half 2024: Defensive Rotation, Second Half 2024: Risk-On Recovery Trade

We foresee a defensive rotation next year, followed by a risk-on recovery trade heading into 2025

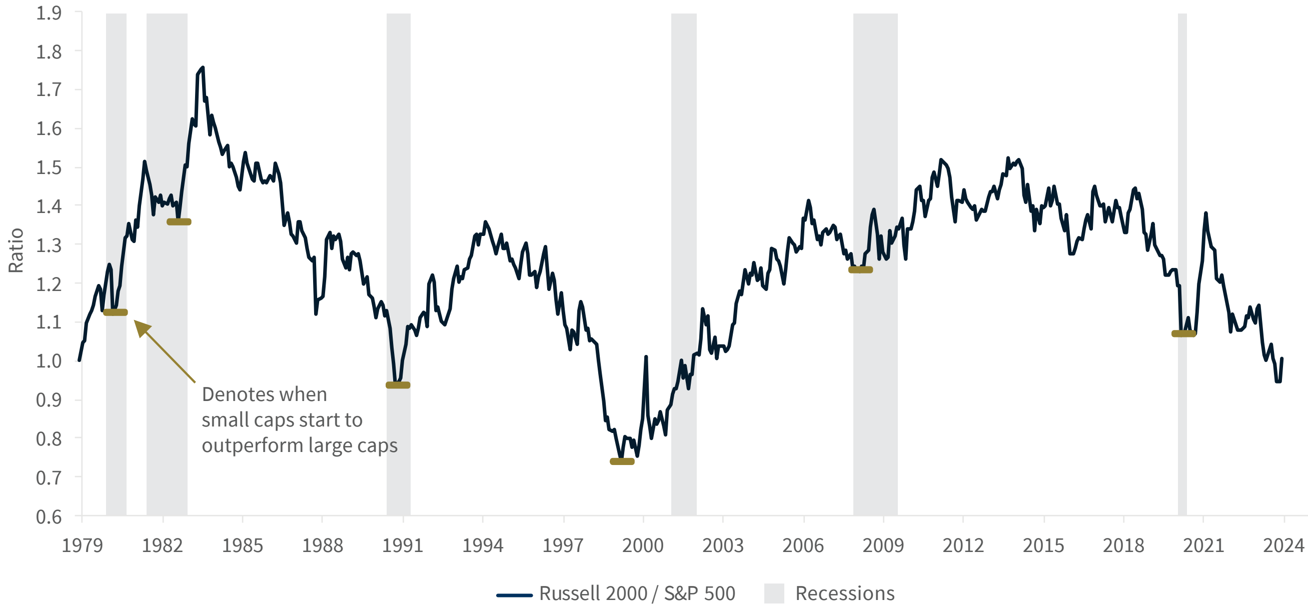


CYCLICALS	DEFENSIVES
• Consumer Discretionary • Energy • Financials • Industrials • Technology • Materials	• Consumer Staples • Health Care • Communication • Utilities

Source: FactSet, RJ Investment Strategy, as of 12/15/2023
Real Estate sector not included in table due to lack of data.
Real Estate became its own GICS sector in 2016.

Small Caps in The Big Picture

Persistent small-cap outperformance likely awaits the end of the current business cycle



Source: FactSet, S&P Global, RJ Investment Strategy, as of 12/15/2023

SMALL CAP, BIG PICTURE

In our view, compelling valuation opportunities exist for investors in small-cap stocks. After a decade of underperformance, naturally, the small-cap P/E ratio has become extremely cheap relative to that of large caps and history. The last time small caps were this undervalued, they outperformed for many years to come.

While valuations aren't timing tools, we're starting to see catalysts for unlocking the potential reward embedded in smaller stock prices.

First, a less inverted yield curve today and a Fed that has stopped raising rates suggest better times ahead and good news for higher-beta segments of the stock market. In the past, small caps have outperformed large caps when the yield curve was steepening.

Second, the Fed's Senior Loan Officer Opinion Survey indicates that fewer banks are tightening credit conditions for small firms seeking commercial and industrial loans. That's good news for the small-cap arena, where banks are a more important source of financing. Credit is the lifeline to smaller firms, and crucial for keeping their growth 'promise' to investors.

While a convincing turn in industrial output and broader economic rebound would likely give small caps a much-needed boost relative to large caps, we worry about missing the turn in the size cycle. After all, median total returns on the Russell 2000 were positive and outpaced those of the S&P 500 by 3% in recessions, meaning small caps tend to front-run business cycle recoveries. The bottom line is we're much less concerned about another 5-10% down in small caps than we are about capturing the next 20% up.

KEY TAKEAWAYS:

- Despite an economic soft patch, a mid-single-digit return could lift the S&P 500 to 4,850 next year.
- A mild recession should produce below-consensus earnings of $225 or 2-3% YoY growth in 2024, whereas cooling inflation and falling interest rates may support a lofty multiple of 21.5x earnings.
- We expect the deeply oversold Health Care and Consumer Staples sectors to benefit from earnings rebounds beginning in early '24. The pro-cyclical Consumer Discretionary, Financial and Industrial sectors should lead a risk-on recovery trade later in the year.
- Lagging small-capitalization stocks are extremely cheap relative to their larger brethren, but a business cycle contraction and ensuing recovery could be agents of change.

Macro Uncertainty, Micro Opportunities

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

Despite a constant barrage of uncertainty throughout the year mired in changing market narratives, equity markets managed to scale the proverbial wall of worry. On the surface, the S&P 500 made an incredibly strong recovery in 2023. Dig a little deeper and it's clear that the average stock had a very different experience. Extreme narrowness from both a sector and size perspective characterized the market throughout the year as investors gravitated to the perceived safety of the largest companies. While elevated macro uncertainty is unlikely to recede in 2024 as the long and variable lags of monetary policy pressure economic growth, the extreme narrowness of 2023 has created ample opportunities for investors. The key is to lean into quality—profitability, earnings growth, free cash flow, lower leverage—across all investments going forward. Selectivity matters more than ever.

1. Lean into quality investments. The days of zero interest rate policy are gone and even if we start to see rate cuts in 2024, real rates (and thus the real cost of capital) are likely to remain elevated. This increases the importance of not only profitability, but also owning parts of the market where earnings growth will reaccelerate next year. Consequently, investors should look for high quality companies (i.e., attractive Return on Equity (ROE), robust Free Cash Flow (FCF), strong balance sheets, increasing earnings momentum) that are still trading at reasonable valuations. Industrials look attractive as ROE is now at a premium to the market, earnings in industries like aerospace and defense have inflected and there is long-term structural support given reshoring trends and the need for higher capex in the next economic cycle.

2. Everything is (no longer) going wrong for small caps. It has been an incredibly difficult ride for smaller companies over the past year. Continued calls for recession have kept investors on the sidelines, leading to the widest performance dispersion between large- and small-caps since 1999. Valuations—both absolute and relative to large caps—are at the lowest levels since 2001, perhaps one of the reasons that M&A activity has picked up for small caps. Critically, earnings are bottoming and are poised to reaccelerate in 2024, providing a catalyst for investors. The impact of higher borrowing costs has also been overstated with balance sheets of small caps in good shape with near record levels of cash. Investors should consider adding some torque to their portfolios with small caps.

3. Select opportunities in emerging markets. Emerging markets are emerging again thanks to stronger national balance sheets, better monetary policy and reduced reliance on foreign funding. Dispersion will likely remain high, increasing the importance of selectivity. China remains problematic given economic and geopolitical challenges, but Asia ex-China has seen improved market breadth as growth reaccelerates and supply chain diversification benefits these markets. India also remains attractive after two years of strong equity performance. Economic growth momentum can continue while improving earnings growth and margins across sectors can lead to further equity upside in 2024. Emerging markets are also generally cheap and under-owned, providing an attractive diversification opportunity for investors.

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A Desynchronizing World: Slowing Growth, Decelerating Inflation, Policy Easing

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

The lagged impact of restrictive monetary policy around the world will exert downward pressure on the global economy in 2024. Activity across advanced economies outside the United States will be below trend and while the picture across emerging economies will be more mixed, the overall view is one of subdued growth marking the cyclical trough before a partial recovery in 2025. More encouragingly, global inflation has fallen sharply from peak levels in late 2022 and will fall further in 2024 driven in particular by lower food and underlying price pressures as activity weakens and labour markets slowly loosen. Across advanced economies, inflation will decelerate to target levels sooner than envisaged by the European Central Bank and Bank of England, a backdrop allowing a policy pivot towards easier monetary policy as the year progresses. Japan is different, monetary policy inching slowly towards partial normalization after years of ultra-easy conditions. Thus, the backdrop presents a challenging set-up for financial markets already priced for a smooth transition to a perfect landing. The stage is set for sovereign bond yields to fall and yield curves to steepen while the equity earnings cycle will trough over the first half of the year before reviving thereafter.

> Across advanced economies, inflation will decelerate to target levels sooner than envisaged by the European Central Bank and Bank of England, a backdrop allowing a policy pivot towards easier monetary policy...

JAPAN

Nowhere does uncertainty regarding prospects for investors over 2024 exist more than in relation to Japan and specifically the outlook for the country's monetary policy. The Bank of Japan is undertaking a detailed review regarding the conduct of policy which will be completed by midyear, however, a

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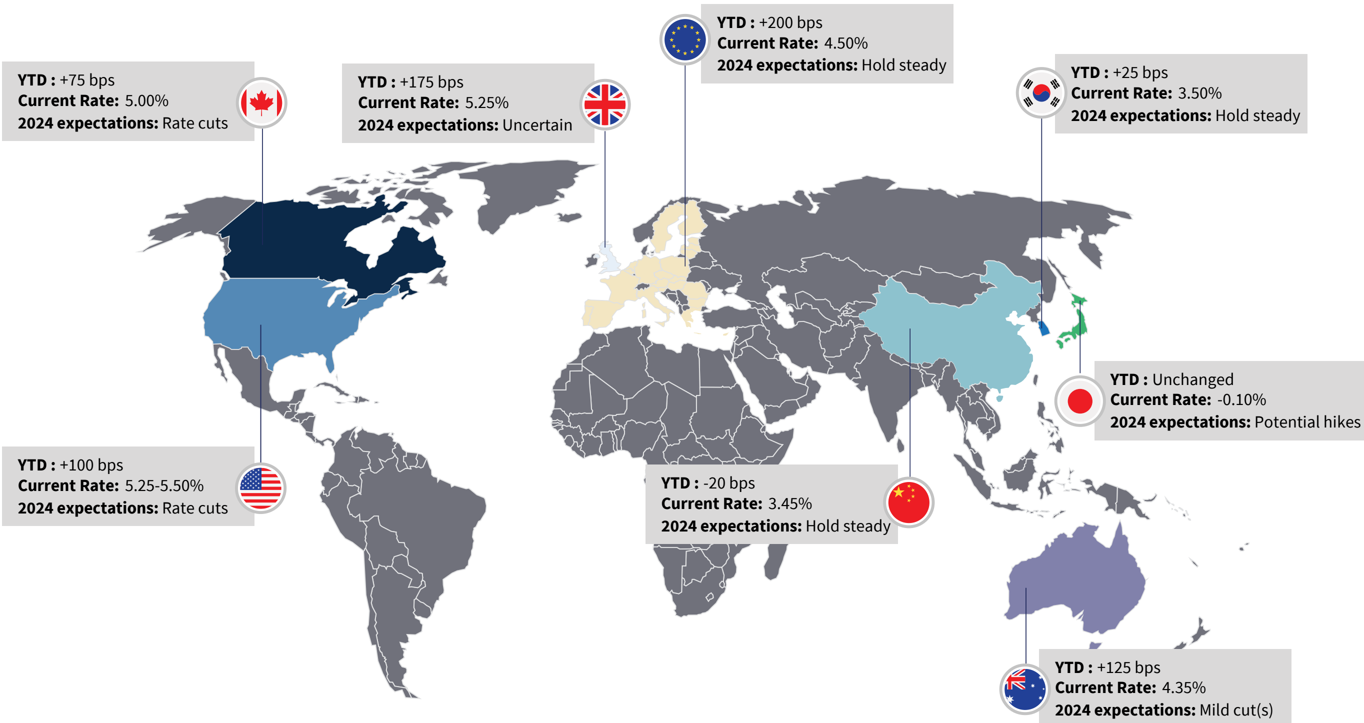
Global Central Bank Policy Expected to Diverge

Tightening cycle moved in sync, pace of loosening will differ



Source: FactSet, as of 12/18/2023

recent adjustment (loosening) to the previously hard ceiling above which government bond yields may not be permitted has de facto signaled that yield curve control is effectively over. But the Bank's bond purchases continue, and confusion exists because the central bank and the Japanese government are trying to step away from tight management of the bond market while simultaneously preventing the yen from further weakness and supporting demand through fiscal stimulus at the same time. A gradual departure from the policies of the past, including taking interest rates out of negative territory would prove supportive to the currency and encourage international interest in the equity market.

EURO AREA / UK

Less equivocation surrounds economic prospects for both the euro zone and the UK. Activity will underperform consensus forecasts over 2024, a shallow economic contraction the likely outcome in large part the consequence of the lagged impact of aggressive monetary policy tightening and a deepening credit crunch reflecting the steady withdrawal of credit availability and persistent deterioration in bank lending, both to businesses and households. Admittedly, falling inflationary pressures will impart less of a drag on consumer spending, but this will be offset by a loosening labour market and tighter fiscal policy. Meanwhile higher debt interest costs and subdued business confidence will weigh on investment intentions. Inflation will continue to subside as 2024 progresses, but the European Central Bank and Bank of England will require convincing that price pressures are sustainably on course to hit 2% targets before easing monetary conditions. A likely election in the UK further complicates prospects, but generally, government bond yields will continue to ease lower and corporate earnings will trough over the first half of the year.

CHINA / INDIA

Following a surge in activity associated with economic reopening in the wake of 2022's pandemic-induced lockdowns, the Chinese economy has lost momentum. This has resulted in an appreciable pick-up in policy support which will deliver a modest cyclical revival, even as trend growth stagnates. Beijing's stimulus efforts have stepped up in response to weakness in the real estate sector and continued caution amongst households reflected in still subdued spending and a greater preparedness to shift savings from property and financial assets into the comparative safety of bank deposits. The People's Bank of China has cut policy rates and embarked upon other measures to revive credit demand which will deliver stability if not a sustained turnaround given the ongoing structural headwinds associated with demographic trends and diminishing returns on investment. A more constructive tone to communication with the United States points to a slow thawing in hitherto frosty relations between the two superpowers, but profound mistrust will take longer to shift.

> "Prospects for India's economy over the longer term are more promising than for most major economies."

In contrast, India will remain the global leader in terms of GDP growth in 2024, even though recent indications suggest activity slipping from earlier high levels. Inflationary pressures will continue to moderate, allowing the Reserve Bank to begin cutting interest rates. Prospects for India's economy over the longer term are more promising than for most major economies. The country is the most populous nation on the planet and will replace China as the world's largest labour force within the next few years. The economy stands to benefit from continued friendshoring of manufacturing supply chains supported by low costs and ongoing structural reform. Parliamentary elections in April/May will be watched closely in relation to Prime Minister Narendra Modi's grip on power.

EMERGING MARKETS

Unlike the outlook for advanced economies, economic activity will have troughed in the Asia Pacific region over 2023, with growth poised to rebound in 2024 supported by easier monetary policy as regional central banks respond to the adverse impact of weakening global demand on trade activity and the continued decline in underlying inflationary pressures. This should be sufficient to offset the adverse impact of sticky headline prices, the consequence of less beneficial energy price basis effects and elevated food prices the consequence of El Niño weather conditions.

Brazil and Mexico have outperformed their American counterparts in GDP terms over 2023, but this will reverse in 2024 as regional central banks continue to cut interest rates and at a faster pace than emerging economies elsewhere. The outlook for the Argentinian economy remains highly uncertain following S. Javier Milei's presidential election victory. Reform is promised, although his ability to drive through the most aggressive aspects of his policy agenda will face a stiff challenge from the Peronist-dominated parliament.

Prospects for the emerging economies of central and Eastern Europe remain bound by both the uncertainty surrounding the ongoing conflict in Ukraine and slowing economic activity across the euro zone. Although the energy-induced inflation shock of 2022 has unwound and monetary policy loosening has further to run, local currency depreciation against both the dollar and euro will continue, the consequence of slowing global growth and still high inflation differentials.

KEY TAKEAWAYS:

- Global growth will slow further in 2024, the consequence of the lagged effect of increasingly restrictive monetary policy.
- More encouragingly, global inflation has fallen from peak levels in 2022 and will fall further in 2024 as underlying price pressures decelerate.
- Inflation falling to target levels will allow for a central bank policy pivot to an easing bias. Japan is the exception, envisaged policy normalization represents a departure from ultra-easy monetary policy conditions and a strengthening yen.
- The Chinese economy will experience a cyclical revival off 2023 lows, but impediments to a structural recovery will remain. The pace of future growth will slow.
- Against this backdrop, the set-up for international financial markets is challenging when already priced for a smooth transition to a near-perfect landing.
- The political cycle converges in 2024; in India, the European Parliament and likely in the UK. The extent to which politics serves to derail the outlook represents a potential threat.
- The stage is set for bond yields to fall and yield curves to steepen. The earnings cycle will trough before recovering, a revival in part based on the continued adoption of artificial intelligence.

Two Wars in Two Years: Stark Reminders About Energy Security

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

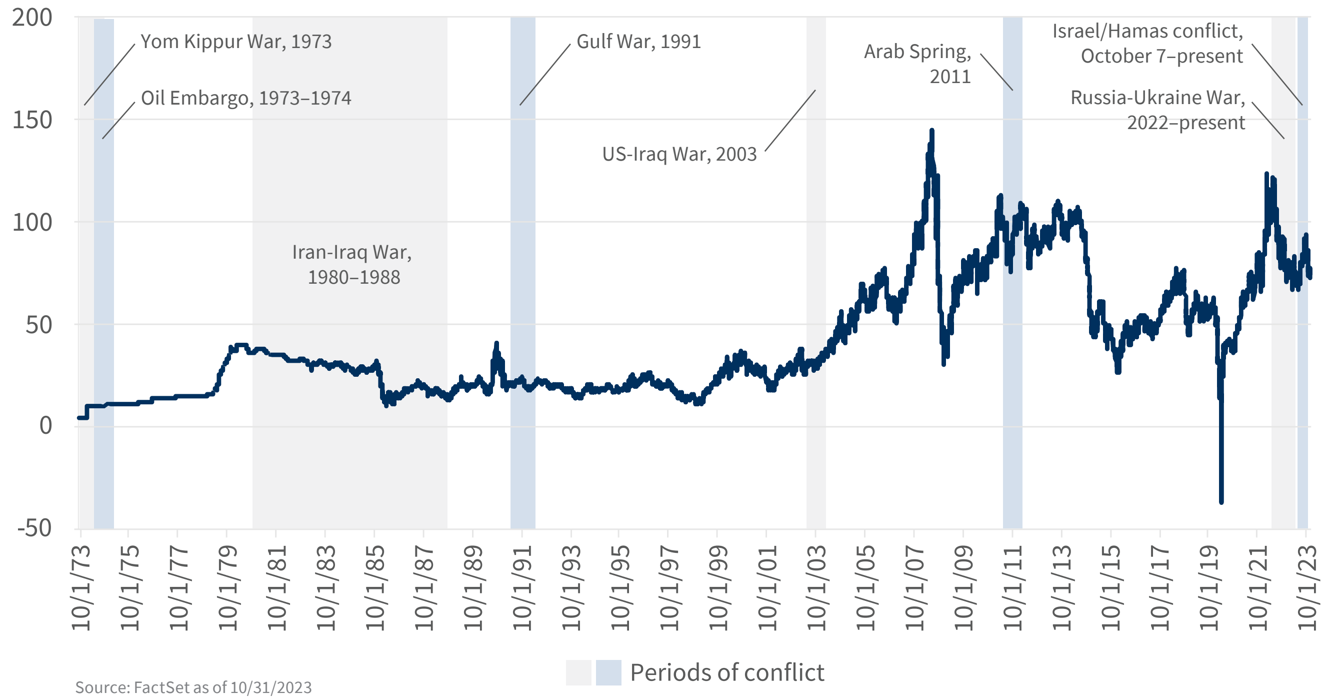
Half a century ago—October 1973—marked the beginning of an era-defining episode in history: the Yom Kippur War and the subsequent Arab oil embargo of 1973-1974, when individuals and businesses on both sides of the Atlantic found themselves literally out of gas. When Hamas attacked Israel in October 2023, the resulting war did not lead to a physical disruption of oil supply—in that sense, the two situations are different, but if anyone needed a reminder of just how vital energy security is, the latest Middle Eastern conflagration provided a stark wake-up call. In fact, it was the second such wake-up call over the past two years. Let's recall that Russia's invasion of Ukraine in February 2022 led to dramatic changes in Europe's energy sector, as the Kremlin deliberately cut off exports of natural gas into the European market, in a failed attempt to bring the European economy to its knees.

OIL: SUPPLY AND DEMAND

Geopolitical conflict vis-à-vis Russia and the Middle East naturally tends to increase oil prices. We are also observing an unusually high degree of production discipline by the OPEC+ coalition, with Saudi Arabia having been aggressive about curtailing supply for the purpose of propping up prices. Likewise, the private sector oil and gas industry in the post-COVID era has become more capital disciplined than ever before, which explains why there are fewer rigs running as compared to past periods when oil prices were at current levels. Global oil and gas capital spending fell by approximately 30% between 2013 (the all-time peak) and 2023. By definition, less investment in new oilfields translates into less supply growth. The counteracting variable is pressure on global oil demand resulting from tight monetary policy around the world. All of the major economies continue to face above-average macro risks, which helps explain why oil has stayed below $100/Bbl since mid-2022. All that being said, we forecast that West Texas Intermediate (WTI) crude will average $75/Bbl in 2024, little changed from the 2023 average. Brent crude, the global benchmark, should remain a few dollars above WTI.

> The private sector oil and gas industry in the post-COVID era has become more capital disciplined than ever before.

WTI Crude Oil Prices During Conflict



Source: FactSet as of 10/31/2023

EUROPE NO LONGER DEPENDENT ON RUSSIAN GAS

Natural gas is fundamentally regional in nature: prices on different continents can follow different patterns. Recall that European natural gas prices peaked in the second half of 2022, when the first summer without Russian supply led to widespread fears about wintertime energy shortages. Ultimately, the European economy has been successfully disentangled from its historical dependence on Russian natural gas—via a combination of liquified natural gas (LNG) imports from overseas, energy efficiency and renewables—and thus prices over the past 12 months have been vastly lower than the unprecedented levels of 2022. Bearing in mind that the US is an important source of LNG for the European market—in other words, a substitute for Russian supply—lower natural gas prices in Europe have some effect on the domestic market. In 2024, we envision the domestic Henry Hub benchmark averaging $4.00/Mcf, roughly halfway between the 2022 and 2023 averages.

While share prices of oil and gas companies continue to fluctuate with commodities, the energy transition megatrend is alive and well. In 2023, solar installations, green hydrogen deployments and electric vehicle sales all set records globally—despite the headwinds from high interest rates (raising the cost of capital for project developers) and lingering supply chain complications. Contrary to conventional wisdom, China is leading the way in many aspects of decarbonization, even though it still burns more coal than the rest of the world combined. One out of every three light-duty vehicles sold in China during 2023 were EVs—the highest share among the G20 major economies—as compared to one out of four in Europe and less than 10% in the US market. Let's also bear in mind that China is the world's largest oil importer, and the EV boom is starting to affect oil demand there. Meanwhile, China's dominance on the supply side of the equation—three-fourths of the world's solar modules and lithium-ion batteries are manufactured there—is such that there are serious concerns in Washington and Brussels about supply chain security. On both sides of the Atlantic, governments are writing big checks to support the expansion of clean tech manufacturing, thereby reducing reliance on imports from Asia.

> All of the major economies continue to face above-average macro risks, which helps explain why oil has stayed below $100/Bbl since mid-2022.

> “While share prices of oil and gas companies continue to fluctuate with commodities, the energy transition megatrend is alive and well. In 2023, solar installations, green hydrogen deployments and electric vehicle sales all set records globally.”

SUPPLY CHAIN SECURITY

Speaking of supply chain security: Development of energy infrastructure, whether fossil fuel or renewable, requires a wide variety of metals. It is interesting to observe the extent to which metal prices traded in very different ways in 2023. Iron ore and steel were up significantly, despite the economic slowdown in China, which produces and consumes as much steel as the rest of the world combined. By contrast, lithium—which had been the world's best-performing commodity, period, in 2021—was down sharply. While few of us are accustomed to thinking about metals through the lens of "will a hostile government deliberately withhold supply?", there is no avoiding some geopolitical risk here. For example, a sizable portion of the world's nickel is mined in Russia. Lithium is extracted mostly in Australia and South America, but the bulk of it is processed in China. To underscore, both lithium and nickel are critical materials for EV batteries.

Amid the focus on reducing carbon emissions, there is also an important role for climate adaptation, and arguably the number-one case study is water scarcity. Looking ahead to the summer of 2024, it is a safe bet that heat waves will once again dominate the headlines. Global records were shattered in 2023: each month from June through November was the hottest in recorded human history. The consequences include reduced productivity of hydropower (this is a serious issue in Brazil and Canada) and outright water shortages (we have seen this in India, South Africa, and California in recent years). There are also more frequent power grid outages, which bolsters demand for distributed generation (such as fuel cells and rooftop solar) and power storage solutions. Simply put, all of us must learn to live with the reality of temperatures that are already above long-term norms and are certain to trend even higher between now and 2050, despite efforts to curb emissions.

KEY TAKEAWAYS:

- Energy security is vital and the latest Middle Eastern conflagration is the second wake-up call over the past two years.
- We are experiencing an unusually high degree of production discipline amongst OPEC+ and capital discipline in US producers.
- We forecast that West Texas Intermediate (WTI) crude will average $75/Bbl in 2024, little changed from the 2023 average. Brent crude, the global benchmark, should remain a few dollars above WTI.
- The energy transition megatrend is alive and well. In 2023, solar installations, green hydrogen deployments and electric vehicle sales all set records globally.
- There are serious concerns in Washington and Brussels about supply chain security.

Economic Snapshot

EUGENIO J. ALEMÁN, PhD
Chief Economist

Headline inflation has weakened more than expected on a year-over-year basis since the middle of 2023 driven by lower energy prices, while core consumer inflation has continued its slow disinflationary process. Shelter costs continue to be the last shoe to fall and are likely to contribute to lower inflation in 2024 as lags in rent and home prices start to be reflected in the economic data. Stronger than expected economic growth and the resilience of the labor market have led the Federal Reserve (Fed) to announce rate cuts this year unless a very negative inflation surprise occurs. Additionally, the labor market is likely to soften, with the unemployment rate increasing from the current historically low levels. Despite the expectation of easing financial conditions in the second half of the year, we continue to believe the higher interest rates and modest weakening of the labor market will affect investment and consumption, pushing the US economy into the mildest recession on record, lasting two quarters. Overall, the US economy will still experience positive economic growth, albeit below the country's potential output. The resiliency of the US economy, along with stagnant growth and the prospect of rate cuts worldwide are headwinds for foreign currencies, which should support the US dollar this year.

	ECONOMIC INDICATOR	COMMENTARY
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate over the next several quarters and we expect a mild recession to start in 2Q24.
NEUTRAL	EMPLOYMENT	Nonfarm payrolls have remained strong in 2023, but the labor market has been cooling down and we expect it to weaken further in 2024.
NEUTRAL	CONSUMER SPENDING	Consumer spending has remained relatively strong, but it is likely to weaken over the next quarters as excess savings from the pandemic are fully depleted and student debt repayments have resumed.
NEUTRAL	BUSINESS INVESTMENT	Despite higher interest rates raising borrowing costs, the passage of several bills, including the Inflation Reduction Act (IRA), the CHIPS Act, and the Infrastructure Bill are contributing positively to business investments.
NEUTRAL	INFLATION	Inflation is likely to continue to slow as economic activity weakens over the next quarters. Shelter costs should slow down further and barring any economic shock, headline inflation should go lower over the next quarters.
NEUTRAL	MONETARY POLICY	The Fed turned more dovish at the end of 2023, but is likely to keep rates higher for several more months before starting to lower rates.
NEUTRAL	LONG-TERM INTEREST RATES	The faster-than-anticipated deceleration in inflation, our forecasted upcoming economic slowdown and the Fed easing rates are all likely to contribute to lower long-term interest rates.
NEUTRAL	FISCAL POLICY	Contributions to GDP from government spending this year are unlikely to change significantly despite our call for a recession, as we expect the downturn to be so mild that government intervention should be limited.
NEUTRAL	THE DOLLAR	The US dollar's role as a safe-haven currency during times of global instability, as well as the expectation of slower growth overseas compared to the resilient US economy, should provide stability for the US dollar in 2024.
NEUTRAL	REST OF THE WORLD	We continue to expect a weakening global economy in 2024 despite central banks worldwide turning more dovish.
UNFAVORABLE	MANUFACTURING	The ISM Manufacturing Index remained in contraction for all of 2023, but should start to recover in the second half of the year as the Fed starts to ease rates.
UNFAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	High mortgage rates and rising construction costs have kept this sector in contraction for several quarters. Despite these headwinds, the low supply of homes has kept prices somewhat stable, and lower rates in 2024 might provide some additional relief to the sector.

Sector Snapshot

This report is intended to highlight the dynamics underlying the 11 S&P 500 sectors, with a goal of providing a timely assessment to be used in developing your personal portfolio strategy. Our time horizon for the sector weightings is not meant to be short-term oriented. The views presented here are based on current market conditions and are not necessarily reflective of our thoughts for the entire year.

Most investors should seek diversity to balance risk versus reward. For this reason, even the least-favored sectors may be appropriate for portfolios seeking a more balanced equity allocation. Those investors seeking a more aggressive investment style may choose to overweight the preferred sectors and entirely avoid the least favored sectors. Investors should consult their financial advisors to formulate a strategy customized to their preferences, needs and goals.

These recommendations will be displayed as such:

TALLEY LÉGER
Senior Equity Strategist, Investment Strategy

Overweight: favored areas to look for ideas, as we expect relative outperformance

Market Weight: expect in-line relative performance

Underweight: unattractive expectations relative to the other sectors; exposure might be needed for diversification

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	HEALTH CARE	12.4%	Despite year-to-date losses, the segment has been a consistent outperformer in the year and a half after final Federal Reserve (Fed) interest rate hikes. Also, the sector has been a top performer in contractions as well as a market performer in recoveries because households spend on health care goods and services regardless of the economic environment. Moreover, health care spending has the added structural tailwind of an aging population. Regardless of recent weakness, this sector's earnings growth typically outperforms in recessions, which we expect to materialize next year, helped by relative producer pricing power in the health care industry. The segment should be a key anchor for index-level earnings next year, supported by improving free cash flow and margin expansion. Of all the market segments, Health Care still possesses the highest long-term average return since 1980, and we expect these deeply oversold stocks to benefit from a mean-reverting catchup phase in 2024.
OVERWEIGHT	CONSUMER STAPLES	6.8%	Consumer Staples are usually among the top performers in the wake of the Fed's last rate increase, they've proven resilient in contractions and have held their own in the initial stage of the recovery process. Ironically, Staples have ranked amongst the best earnings growers this year, but investors haven't rewarded the stocks for their strong fundamental performance. Looking ahead, we would expect that relative profitability to persist, as it usually does for these companies in broad business cycle downturns. Technically, this lagging sector has become so deeply oversold that we see more relative upside than downside for these stocks over the next year.
OVERWEIGHT	UTILITIES	2.3%	Utilities have been structural underperformers since 1980 and carry the lowest long-term average return of all sectors. We believe there's a narrow window of opportunity for high-yielding bond-like stocks in the first half of next year. An end to Fed rate hikes, easing bond yields, colder weather and a seasonal boost to utility production could be just enough to produce a tactical reprieve rally for this beaten down sector.
OVERWEIGHT	CONSUMER DISCRETIONARY	10.9%	The Consumer Discretionary sector has usually benefitted from falling interest rates and bond yields. Lower oil and gasoline prices, as well as cooling headline inflation are additional tailwinds. Investors have already rewarded the stocks for their exceptional earnings growth, which may be nearing a peak and a mild economic recession next year could cause consumer cyclicals to pull back. While the segment trades at a slight premium to the market and history, valuations are far from frothy and the stocks never reached overbought extremes, meaning we see scope for additional outperformance on slower but still robust earning growth. Consumer Discretionary is often the first cyclical sector to bottom in recessions and lead the pack in recoveries. As such, we would be buyers on any weakness that materializes.

Continued on next page

MARKET WEIGHT	INFORMATION TECHNOLOGY	28.3%	The Tech sector now trades at a valuation premium, meaning it has priced in a lot of good news. Tech has been one of the strongest earnings producers this year. On the policy front, a lower discount rate should support long-duration stocks like these. In fact, Tech has been a top performer in the wake of final Fed rate hikes; however, there are concerns that Tech may be overbought. As such, we're inclined to take profits from this top-performing sector and re-engage should a major re-rating occur next year.
MARKET WEIGHT	FINANCIALS	13.1%	Financials aren't our favorite place to run for cover in an economic recession. However, we anticipate a reversal of fortune for this lagging sector on the back of a recovery-type of scenario and the benefits that an improving overall market tone would engender (e.g., M&A, IPOs, trading desk volume, loan originations, refinancing). Financial earnings growth has fallen back into negative territory alongside the lagged effects of monetary policy tightening and an inverted yield curve. Looking ahead, we believe the positive 'carry' from a more normally sloped yield curve should help ease the pressure on bank net interest margins. While the Fed deserves a lot of credit for short circuiting the regional banking crisis, unfortunately, the larger well-capitalized financial institutions were also shunned by investors. The silver lining is that Financials already priced in so much bad news that they became extremely oversold and currently trade at a noticeable valuation discount, so there's likely room for positive surprises later next year.
MARKET WEIGHT	REAL ESTATE	2.2%	The aggressive move higher in rates at the long end of the yield curve was a significant headwind for this rate-sensitive sector for most of 2023. As rates peaked in October, the sector finally found its footing and returned 16% QTD. While we continue to believe rates will move gradually lower in 2024, markets (including interest rates) tend not to move in a straight line for very long. As such, we're inclined to remain neutral on the sector given economic uncertainty, tighter lending standards and continued challenges in the Commerical Real Estate space which could create a better opportunity to upgrade in the future.
UNDERWEIGHT	COMMUNICATION SERVICES	9.5%	The fundamentals have been strong for Communication Services and investors have already richly rewarded the segment for its strong earnings growth. Downturns and final Fed hikes don't seem to help this service-oriented sector of the market. Moreover, Communication Services stocks are losing momentum from overbought extremes, which is a concerning technical backdrop. For now, we prefer to lock in gains from this top-performing sector and move to a modest below-benchmark position.
UNDERWEIGHT	INDUSTRIALS MATERIALS	8.2% 2.3%	Industrials and Materials usually thrive in the expansion stage of the business cycle where interest rates and commodity prices are rising on the back of robust nominal global growth. The reality is that those macro drivers are absent in economic downturns, however mild, which we expect to occur next year. The upshot is that the manufacturing recession is an aging theme and much of that bad news has been priced into industrial stocks.
UNDERWEIGHT	ENERGY	3.8%	We see a challenging risk/reward dynamic for the Energy sector in the near term as sentiment will likely remain subdued as we approach the long anticipated recession. Historically, Energy has spiked leading into previous deeper recessions (1975, 1979, 1990, 2001, 2008) and then subsequently declined as economic activity weakened. However, as we anticipate the upcoming recession to be the mildest in history (thereby resulting in minimal demand impacts) and given that supply/demand dynamics are close to equilibrium, we believe oil prices will be more resilient throughout the upcoming downturn. As a result, we see mild upside for oil prices to $85/bbl by year-end 2024. Although we remain cautious in the near term, mild 2H24 upside in prices combined with favorable fundamental dynamics (e.g., highest free cash flow yield of any sector, trading at discount to S&P 500) and recent sector fund outflows could make it a contrarian sector play for full year 2024. The transition to green energy will continue to be an overhang for the sector, but we see this as a longer-term concern and it should not provide a major headwind for the sector in 2024.

Disclosure

All expressions of opinion reflect the judgment of the authors and are subject to change. Past performance may not be indicative of future results. There is no assurance any of the trends mentioned will continue or forecasts will occur. The performance mentioned does not include fees and charges which would reduce an investor's return. Dividends are not guaranteed and will fluctuate. Investing involves risk including the possible loss of capital. Asset allocation and diversification do not guarantee a profit nor protect against loss. Investing in certain sectors may involve additional risks and may not be appropriate for all investors.

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

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The MSCI China A Index measures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. The MSCI Pacific Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region. The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market. The MSCI Europe index is a European equity index which tracks the return of stocks within 15 European developed markets.

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