RAYMOND JAMES

VOLUME 17 | ISSUE 4 | OCTOBER 2024

INVESTMENT STRATEGY QUARTERLY

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Letter from the Chief Investment Officer

The Great American Road Trip

With fall in the air, it's a great time for a road trip! There's something exciting about the American tradition of hitting the road with friends and family in tow. "It's not the destination, it's the journey," Ralph Waldo Emerson said, but he never had to manage portfolios—both are critically important. Why? Because similar to road trips, even as *unexpected detours* occur, investors cannot lose sight of their long-term goals. Case in point: as we look at today's economy and financial markets, we are at a *crossroads*: Will it be a long straight *highway* to a soft landing, or will it be a *bumpy road* to recession? Will November's election results provide a *fork in the road* on taxes and tariffs? And what *road signs* should we follow in positioning portfolios? So, fill up the tank, fire up your playlist, grab snacks, and let's go on a trip to find these answers!

We begin at Raymond James headquarters in sunny St. Petersburg, Florida. Florida is known as the 'sunshine state'—and the economy has been shining brightly over the last four years as it recovered from COVID. Admittedly, a slowdown has been anticipated for a while. But each time consumer, business and government spending proved resilient, our economic GPS said: 'recalculating.' Even the most aggressive Federal Reserve (Fed) tightening in 40 years, a spike in inflation, and slowing consumer spending have yet to cloud economic vitality.

But as our journey heads north along the *Blue Ridge Parkway* through the great Appalachian Mountains, we encounter SLOW AHEAD and FALLING ROCKS signs that speak to our economic forecasts. We expect GDP of 2.6% in 2024 and 2.0% in 2025. The important point is that while the economy is slowing and on a narrow path to a soft landing, it is not expected to crash into a recession. Remember, a slower, more consistent speed is better for gas mileage efficiency. Slowing, but not negative, job growth, healthy business spending, and a continuation in government spending—80% of the Inflation Reduction Act has yet to be spent—to re-industrialize the US should help the economy avert a recession. The 'falling rocks' that could jeopardize our outlook are a precipitous decline in consumer spending—either by buyers' choice or by crushingly high interest rates—dynamics the Fed understands well.

That is why our next stop is Washington, DC, the home of the Federal Reserve. Maybe the Fed isn't a top destination for most road trippers, but it's certainly the most-watched institution for markets as the long-awaited easing cycle has begun. After cutting 50 basis points at its September meeting, the Fed has more cuts in the tank—at least 50 basis points (bps) more in 2024, and at least 100 bps more in 2025. Fed Chair Powell can answer the question "Are we there yet?" with a resounding "yes!" regarding lower inflation and can now focus on sustaining the health of the economy and employment conditions. Lower interest rates are a significant driver of our hoped-for economic reacceleration in 2025.

Next up: a leisurely drive through Pennsylvania, Michigan and Wisconsin—the proverbial 'Blue Wall' that may decide our next president. In these states, the Great Lakes generate uncertain 'lake effect' weather—but it might be easier to forecast these surprise storms than the upcoming election results (let alone how each would govern versus how they have campaigned). We expect the race between Vice President Harris and former President Trump will be a nail-biter. In Congress, our base case is that the Senate flips Republican and that the House flips Democratic. The election outcome will likely impact tariffs, taxes, regulation and fiscal spending priorities. However, we advocate that the economy, the Fed, fundamentals and sentiment have more profound impacts on the markets than politics.

Now we head west—into the 'breadbasket' states of Iowa, Nebraska and Kansas, passing oceans of waving grains. Just as the agricultural production of these states helps sustain our economy, fixed income is a staple part of a portfolio. Like a steady supply of foodstuffs, bonds (particularly high-quality bonds) provide stability and consistent income. And, in times of uncertainty, bonds help dampen volatility. The good news is that the runup in yields from pandemic lows has provided a frugal feast for fixed-income investors starved for higher yields. We forecast bond yields will likely stay relatively stable over the next 12 months, with the 10-year Treasury yield staying in a tight range around 4%. Good farmers know that patience and crop rotation are important. As the Fed continues to cut interest rates, investors should slowly transition their cash holdings to longer-duration bonds. Our favored

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parts of the fixed-income market are investment-grade bonds, particularly short term, and municipal bonds.

Turning southwest, the grandeur of the Texas oil rigs towers over our vehicle. Interestingly, while Texas is still the largest oil-producing state, we must drive further to find the largest oil-producing county. It's New Mexico's Lea County, which sits atop the Permian Basin. Currently, US oil production continues to notch record highs on the back of new technologies and better efficiency, while weak demand from China keeps oil prices low. This supply-demand imbalance causes us to adjust our 12-month target to $75/bbl. Surprisingly, even recent geopolitical skirmishes in the Middle East have not lifted oil prices.

Reaching the West Coast, we cruise along the beautiful Pacific Coast Highway out of San Diego. San Diego's near-perfect weather conditions (not too hot, not too cold) remind us of the equity market. If everything goes 'just right,' we expect a soft landing, more Fed rate cuts, positive earnings growth, and a record amount of cash on the sidelines to support the bull market that we believe has a long road ahead. Our 12-month target for the S&P 500 is 5,850. But our optimism isn't on autopilot. As Southern California drivers can testify, accidents and traffic jams can occur anytime: election uncertainty, the potential for an economic 'growth scare,' and investor over-optimism could be temporary challenges. As we expect small-cap earnings to trough this quarter, it may be time to take the top off the convertible as small-cap equities should enjoy the tailwinds of Fed cuts and the reacceleration in economic momentum over the next 12 months.

Our favorite sectors are still Health Care, Industrials, and Technology. As we pass through the epicenter of tech innovation, Silicon Valley, our technology preference remains steadfast because of its healthy earnings growth, robust buybacks, increased dividends, and still strong competitive advantages. Thematically, with the AI story likely in its early stages, US exposure to tech-related stocks (which is ~42% of the S&P 500) is a key reason behind our preference for the US over other developed markets in the long term. Areas within emerging markets that have some technology exposure, like India, remain on our radar screen.

In our final stretch, we cross over the most photographed bridge in the world—the Golden Gate. It reminds us that our asset allocation goal is to build a bridge from your investments today to a sustainable future. Creating pillars of strength and a suspension system to weather various market conditions maximizes the probability of reaching your investment destination safely. Our trip ends at the iconic Space Needle in Seattle. Like a solid portfolio, it was built to last. From its observation deck, you can see 20 miles into the distance—from the mountains to the water to the city itself. That is the kind of broad perspective you need when managing a portfolio. With your financial advisor riding shotgun, take the long view when it comes to investment decisions; don't be distracted by the day-to-day headline noise. No matter what the road ahead brings, we are *revving our engines* and ready to meet it.

Where to next? We'll see you there. Bring road snacks.

Safe travels,

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

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Trade and Tariffs: The Impact on Consumers

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

A tariff is a tax assessed on imports. Historically, tariffs have been enacted to generate tax revenue or to protect domestic producers from competition in the form of cheaper foreign goods. In essence, tariffs artificially make domestically produced goods more competitive in the local market by making imports more expensive. At the same time, tariffs allow domestic producers to increase the price they otherwise would have charged for their product had they faced foreign competition. In many ways, trade without tariffs keeps domestic producers' attempts to increase prices at bay. While tariffs have been utilized heavily in the past, both their usage and rates have fallen considerably over the past half century as countries have engaged in different stages of trade negotiations. The volume and value of global trade have grown exponentially as tariffs and barriers to trade have fallen over the decades. This has coincided with the growth of the global economy over the same period, which is, on average and in aggregate, more prosperous than at any time in human history.

In essence, tariffs artificially make domestically produced goods more competitive in the local market by making imports more expensive.

While it is readily apparent that emerging economies have reaped outsized rewards because of freer trade, developed economies as a whole have benefited as well. The availability of cheaper imported goods has enabled consumers in developed economies to retain a larger share of their income for consumption, saving or investment. The same holds true for companies, which benefit from lower input costs and higher profit margins when there are fewer barriers to trade. The strength and dominance of the US dollar as the world's

dominant currency, helped by the sizable and consistent demand for US financial assets, the growth of the US economy, as well as the large fiscal deficits over the years, have all contributed to the increase in US consumption and thus to a sizable increase in imports from the rest of the world. This has created a large current account deficit (this includes the trade deficit in goods as well as the surplus in the trade of services), which needs to be financed with foreign savings. That is, the rest of the world has essentially financed the expansion of US consumption by purchasing US financial assets and investing in its economy. In exchange, the rest of the world has been buying US physical assets as well as receiving interest and dividend payments from these transactions. Thus far, this arrangement has, on the whole, greatly benefited the US economy and will remain a non-issue as long as the US dollar remains the world's reserve currency and the US economy the preeminent place to invest.

> Trade is almost always better than no trade.

When tariffs are imposed or increased the price of those goods affected by tariffs rise, potentially increasing inflation. Goods become more expensive to consumers and inputs become more expensive to companies, reducing both purchasing power and profitability, respectively. That is to say, the aggregate impact to the entire economy at large is negative. Furthermore, if nations engage in a 'trade war' wherein each nation retaliates with their own tariffs, which is what happened when the US enacted tariffs the last time, the negative economic effects could be amplified.

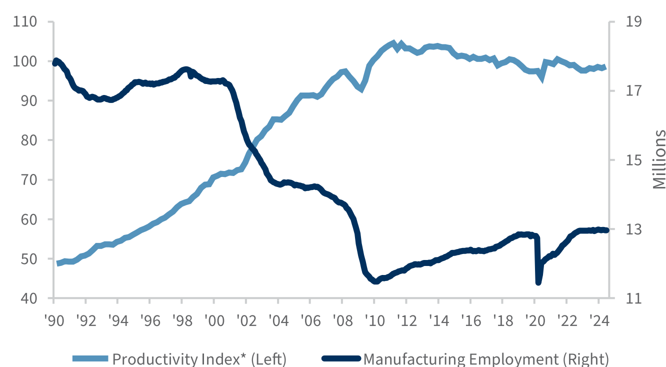
Trade is almost always better than no trade. And, as we mentioned above, the process toward freer trade over the last several decades has benefited the world economy as a whole, not only in terms of economic growth but also in terms of allowing countries to benefit from comparative advantage and produce, and export, products they are the most efficient at producing. We are not saying that there may be some arguments for the imposition of tariffs, but those instances have to be considered on a case-by-case basis. The imposition of blanket tariffs as an argument to solve trade imbalances is not a good way to tackle the root cause of these deficits. Sometimes, governments impose tariffs when they think that countries/companies are 'dumping' or selling products in the international market at prices that are lower than in their domestic market. Other times, governments impose tariffs to temporarily protect a company that is experiencing short-term issues at home, and politicians deem that the company's existence is at risk if the government doesn't intervene. Sometimes a country imposes tariffs if it believes that companies in the foreign country are being subsidized and are improving the competitiveness of their products vis-à-vis domestic companies, etc.

An alternative that can help to reduce the trade deficit, if this was the true reason for the imposition of tariffs, is to reduce the fiscal deficit. However, this is going to slow economic activity as well as economic growth and politicians are probably not going to be willing to consider this avenue for improving the trade balance.

THE 2018 TRADE WAR

The US manufacturing sector has been transformed over the last several decades as cheaper imports have put pressure on the sector's competitiveness. Higher manufacturing wages in the US compared to the rest of the world are probably the root cause of such a shift. According to the National Association of Manufacturers (NAM), the average salary of a manufacturing worker in the US in 2022 was $98,846, including benefits, compared to about $13,638 in China and $15,804 in Mexico.[1] However, the sector's transformation has meant that it is using more machines and more skilled labor to produce goods and this requires fewer workers to produce than in the past. This means that the sector has continued to specialize in the production of those goods that it is most efficient in producing. That is, although employment in manufacturing declined by nearly 30% since the 1990s, manufacturing productivity has doubled during the same period. This increase in manufacturing productivity has meant that manufacturing workers are highly paid compared to workers in the developed world.

Manufacturing Productivity Has Doubled Since the 1990s



Source: FactSet, data as of 9/30/2024
*Productivity Index is measured as total output per hour worked

[1] https://nam.org/manufacturing-in-the-united-states/facts-about-manufacturing-expanded/#:~:text=Manufacturing%20employees%20earned%20%2498%2C846%20on,2022%2C%20including%20pay%20and%20benefits.

During the Trump presidency the US raised tariffs on many US trading partners, tariffs that the Biden administration has kept almost unchanged. China was affected the most, with over $380 billion worth of steel, aluminum, washing machines and solar panels impacted by tariffs, for a total increase in tariff revenues of ~$80 billion. It has been estimated that the average household has paid an additional ~$300 annually due to the 2018 trade war.[2]

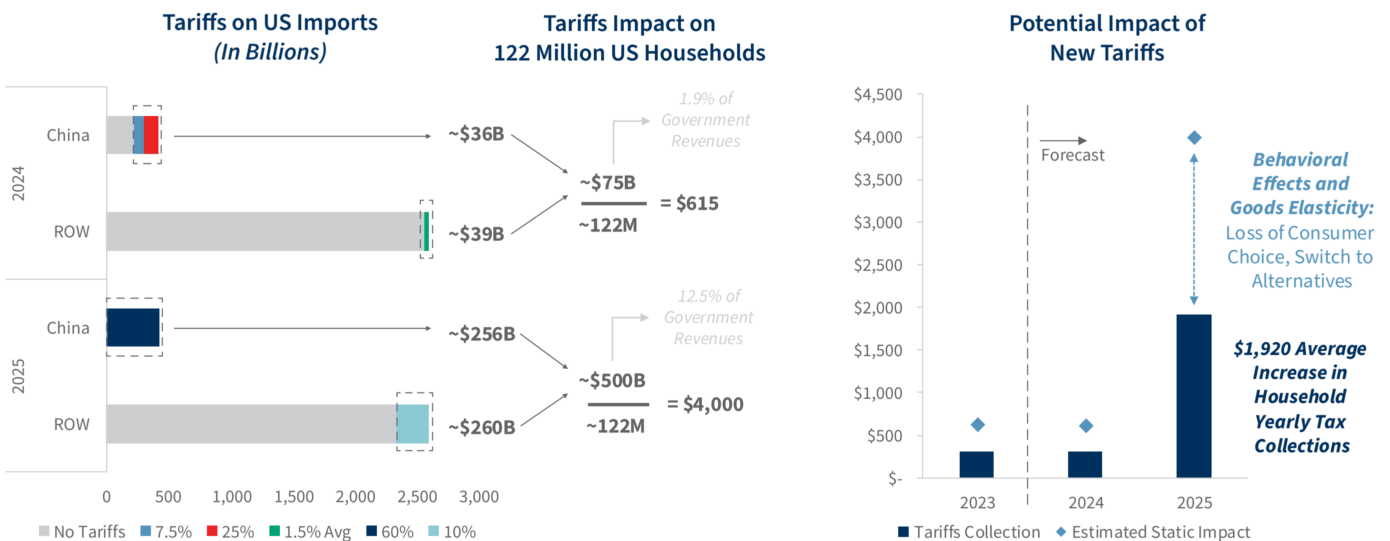
A POTENTIAL 2025 TRADE WAR?

The COVID-19 pandemic, the government's massive fiscal package, the inflation spike of 2022, and the Federal Reserve's (Fed) monetary policy journey have certainly overshadowed any impact that the 2018 trade war might have had. However, that's behind us, pandemic excess savings are depleted, inflation is close to the Fed's target, the Fed has started to ease rates, and we are now staring at the possibility of a new trade war. While trying to estimate the effects of additional tariffs and potential retaliation from foreign countries is an extremely complex task with lots of variables at play, we've tried to estimate the potential impact on the US economy from the imposition of a 10% import tariffs on all trading partners and 60% tariffs on all Chinese imports.

Under this scenario, the tariffs will generate ~$500B in revenues, which could, on one hand, have a negative impact on GDP if the revenues from tariffs are not returned to the economy. Typically, higher tariffs are paid by consumers through higher prices for the goods they consume. Furthermore, the impact on consumers, especially those in the lower income quintiles, could be severe as not only are they likely to have fewer options, but may be forced to spend much more as businesses will likely pass the bulk of the price increase to consumers. On the other hand, domestic producers will likely attempt to use the impact of tariffs on imported goods to boost their profit margins by increasing prices of competing domestically produced goods. Overall, if tariff revenues increase more than sixfold (from $80 billion to $500 billion) then the extra amount that the average household will have to pay increases from ~$300 annually to ~$1,900 annually and impacts the US economy by as much as 1.9% of total GDP.

If these tariffs are enacted, a trade war is likely to ensue as trading partners retaliate by imposing similar tariffs on US exports. In this escalation, the trade deficit will likely widen further, and US exporters may experience as much as a ~$400B hit on revenues depending on how much the quantity demanded by trade partners will decline. Additionally, if the US dollar were to appreciate in response to the tariffs, US exporters would have a harder time selling their products overseas, which would likely have a negative impact not only to exports, but also to US production and the labor market.

Inflation is likely to increase as tariffs are implemented and prices increase, but unless the trade war continues over the years, the inflation spike may be short-lived. However, if inflation increases then the Fed may be pushed to either increase interest rates or keep interest rates higher for longer compared to a no-tariff-war scenario or until the effects from the tariffs are pushed through the US economy. It is difficult to know the actual impact on overall inflation, but an across the board increase in tariffs has the potential to push inflation higher.



Source: FactSet, TaxFoundation.org, US Census Bureau, US Customs and Border Protection, US Trade Representative

[2] US Customs Border Patrol, US Trade Representative, Tax Foundation sources

> An across the board increase in tariffs has the potential to push inflation higher.

CONCLUSION:

Those who believe that freer trade is not good for a country believe that international trade is a 'zero-sum game,' which means that if one country loses, that is, has a trade deficit, then the country with the corresponding, and opposite, trade surplus, is the winner. However, trade is, typically, not a zero-sum game but a 'positive-sum game' in which everybody wins by engaging in trade. The idea that a trade surplus is better than a trade deficit comes from the old and discarded theory of 'mercantilism,' a view of the world that lasted from the 16th to the 18th centuries and that considered the wealth of a nation dependent on the size of its trade surplus while limiting imports through the imposition of tariffs.

However, the reality is more complex. As discussed above, trade deficits and surpluses do not necessarily denote whether a nation is at an inherent economic advantage or disadvantage. In this sense, trade is more like a 'positive-sum game' with a variety of possible payoffs. Generally speaking, all nations stand to benefit by 'cooperating' in an environment of freer trade. However, tariffs and protectionist measures disrupt global supply chains, increasing costs and reducing profitability. In other words, nations stand to be harmed by 'defecting' from free trade and engaging in trade wars.

KEY TAKEAWAYS:

- A tariff is a tax on imports.
- Historically, tariffs have been enacted to generate tax revenue or to protect domestic producers from competition in the form of cheaper foreign goods. Imports are made more expensive so domestically produced goods can be more competitive in the local market.
- When tariffs are imposed or increased the price of the goods rise, potentially increasing inflation. Goods become more expensive to consumers and inputs become more expensive to companies.
- China has been most affected by US tariffs imposed by former President Trump and continued by President Biden.
- In our view, the imposition of further tariffs should be considered on a case-by-case basis, rather than applied as a blanket strategy to decrease a trade deficit.

Final Stretch Before Election Day: Everything & Nothing Has Changed

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

A series of unprecedented and historic events has completely shifted the candidates and dynamics of the race for the presidency and Congress—yet the key issues and likely market impacts of the race remain largely the same, following the entry of Vice President Kamala Harris as the Democratic challenger to former President Donald Trump. Despite a notable shift in sentiment and momentum behind Harris (compared to when Biden was the nominee) the race is likely to be close through Election Day. Given this unpredictability, we caution against viewing individual incremental shifts in either direction (especially in polling) as clear evidence that either candidate is headed to victory. On the policy/market front, while both Trump and Harris have offered some previews of their respective agendas, policy specifics will still need to be filled including monitoring who is selected for key roles in either Administration. Control of Congress will also play a key role in the ability of either candidate to enact his or her agenda. Republicans have a clear advantage in the Senate and Democrats have a slight advantage in the House, but a sweep by either party remains a real probability—adding additional uncertainty to the 2025 agenda and market reaction. From now until November, we will be watching for a series of known factors (including longer-term momentum in polling trends and favorability statistics) and unknown factors—for example, whether the wave of momentum shifts behind either candidate heading into November, or whether the race definitively becomes framed as a referendum on either candidate.

The biggest change in the race (aside from the nominees) has been the resurgence of momentum and enthusiasm within the Democratic base.

HOW HAS THE STATE OF THE RACE BEEN UPENDED?

The biggest change in the race (aside from the nominees) has been the resurgence of momentum and enthusiasm within the Democratic base, compared to when President Biden was the nominee. While expectations of a 2020 rematch dominated much of the election conversation in the past year, we have consistently highlighted the possibility of unexpected events upending the race.

Those unexpected events have since occurred in spades, with the poor performance by President Joe Biden at the June presidential debate kicking off the series of events that led to his historic withdrawal from the Democratic nomination and Harris' rapid ascent to the top of the ticket. Harris' clinching of the nomination was met by a material uptick in Democratic voter enthusiasm—with likely down-ballot impacts—as well as fundraising dollars and polling numbers. This will be especially impactful in House races in New York and California, where there are eight Republican House members in races that are rated as 'toss-up.' While New York and California are unlikely to be competitive at the presidential level, higher turnout among Democrats could be decisive in these House races and potentially determine the outcome of the House majority.

HOW HAS THE STATE OF THE RACE REMAINED THE SAME?

To win the presidency, a candidate needs to secure 270 Electoral College votes and the structure of the Electoral College favors Republicans. As in recent presidential elections, a small set of voters in a handful of swing states are likely to determine the outcome of the 2024 presidential election. Pennsylvania is emerging as a potential tipping state, with the candidate who wins Pennsylvania having the likeliest path towards the 270 Electoral College votes necessary to win the presidency.

A key metric we follow in presidential elections is favorability ratings – something we frequently highlighted as a significant warning sign of the reelection bid of President Biden. The favorability rating can

> It does not change the reality of what the race is likely to come down to: a small set of voters in key swing states (especially Pennsylvania).

be a proxy for an individual's willingness to vote for a candidate. In 2016 and 2020 each presidential candidate had a net-negative favorability rating, which led to a discussion on who can win votes, despite a negative view. We will be monitoring the favorable/unfavorable ratings of each candidate to see if it provides insight into who can win over a majority of undecided voters.

The market impacts of the range of electoral outcomes have also not changed on a fundamental level. We largely view Harris' policy platform as an extension of Biden's on key issues including trade (where we would expect a continuation of the current targeted tariff approach) and tax, where we would likely see a push to raise the corporate rate and potentially allow the individual provisions of the 2017 individual tax changes to expire. While we have gotten some additional clarity as to Harris' specific policy priorities with regard to the cost of living and taxation, the lack of a traditional nominating process reduces the amount of policy details.

Recent calls from Trump for a 60% tariff on all Chinese goods and a 10-20% global tariff are a key example of a dynamic to consider when assessing the market impact of a potential second Trump

	TAXES	TARIFFS & TRADE	HOUSING
HARRIS	Higher taxes on corporations & wealthy, renewal of child tax credit	Supports domestic production, tax credits for small businesses	Tax credits for builders, down payment assistance for first-time homebuyers
TRUMP	Reduce taxes/ extend tax cuts	Impose 10% tariff on all imported foreign goods, 60% on items from China	Open federal land for development, eliminate regulations

term: these policy proposals should be taken seriously, but not literally. Our conversations with DC contacts reaffirm our expectation that while a Trump victory would likely bring changes to impactful policy areas including tax, immigration, tariffs and geopolitics, the specifics are not set in stone—and influenced by who is appointed to key roles. The changes in regulation would also be a notable change in a second Trump term compared to the Biden Administration. Equities in heavily regulated industries could see a positive sentiment shift following the election, but we always advise that the regulatory environment is only one of many factors to consider when making investment decisions.

ARGUMENTS FOR AND AGAINST EACH CANDIDATE

As we enter the final stretch of the 2024 election, the race between Harris and Trump remains highly competitive, and there are compelling arguments that either candidate could win. Arguments in favor of Trump include his strong base of support, the Republican advantage in the Electoral College, and historical polling misses that have underestimated his support. Conversely, there are concerns about stalled momentum, underwater favorability ratings and a 'low ceiling' (46% in 2016 and 47% in 2020) with voters in the previous elections.

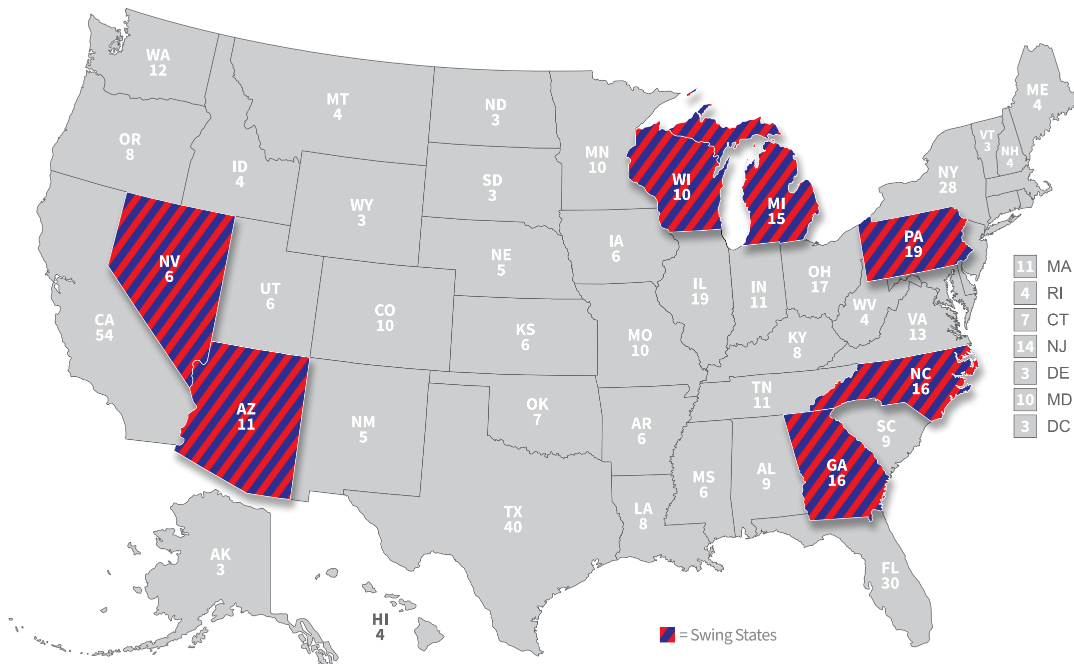
> There are compelling arguments that either candidate could win.

For Harris, she has seen enthusiasm within the Democratic base, has achieved record-breaking fundraising numbers, has polling momentum compared to Biden's performance, and dramatically increased her favorability rating. However, we would also highlight the structural disadvantage for Democrats in the Electoral College, and previous polling misses overcounting Democratic support. Importantly, only one sitting vice president (George H.W. Bush in 1988) has been elected president in the last 188 years.

With weeks left until Election Day, both candidates are intensifying their efforts to sway undecided voters and energize their bases. In the remaining weeks and with the above arguments in mind, we are watching several key factors that could shape the final result of a very tight race, including how the race is framed in the media, performance in battleground states, polling, voter turnout and campaign spending.

Battleground States

The race is likely to come down to a small number of voters in key swing states.



BATTLEGROUND STATE ELECTORAL STRATEGY

The election will likely be decided in seven key swing states: Arizona, Georgia, Michigan, Nevada, North Carolina, Pennsylvania, and Wisconsin. In addition to these seven states, swing districts in Nebraska and Maine, which award single Electoral College votes, will also receive significant attention. Increasingly Pennsylvania is looking like the key state where a win for either side would make it very difficult for the other candidate to capture the necessary 270 electoral college votes necessary to win the presidency. One important note about Pennsylvania is a law that forbids opening mail-in ballots until 7 p.m. on election day. Like 2020, a close election in PA could take days to clearly identify a winner.

POLLING DATA

We receive many questions about polls. While they can be a useful tool to get a general sense of the direction of a political contest, we recognize their limitations. In 2016 and again in 2020 public polls undercounted the final strength of Donald Trump at the national and swing state level. In 2016 polls under reported the final vote total for Donald Trump by 3.43% and 2.28% in the swing states. Polling errors can occur in either direction, with the 2012 election undercounting the strength of Barack Obama by 1.43%. The closer the final polling data, the greater the probability of another surprise on Election Day.

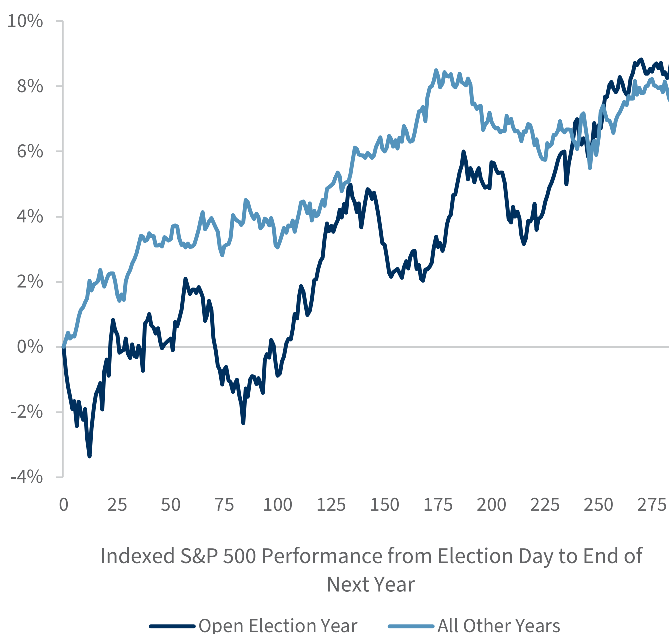
MARKET VOLATILITY AROUND ELECTIONS

As the election approaches, investors should be prepared for increased market volatility—typical in the lead-up to elections. We have seen periods of weakness when there is the greatest amount of uncertainty, especially when a sweep by either political party becomes increasingly likely. We view our job as trying to bookend the risks and opportunities of various DC-related decisions. It is easier to provide narrower bands of outcomes when the election outcomes are known, especially when there is split government. When the House, Senate and White House are all controlled by the same party—more policies become possible, and outcomes become harder to predict.

That said, despite the current close race and potential for numerous factors to sway the outcome, it is crucial for investors to maintain a long-term perspective. Historically, while preelection periods often experience heightened volatility, the first year of a new presidential term typically sees positive market returns, regardless of which party wins the White House.

Equities Rally Following Election Day

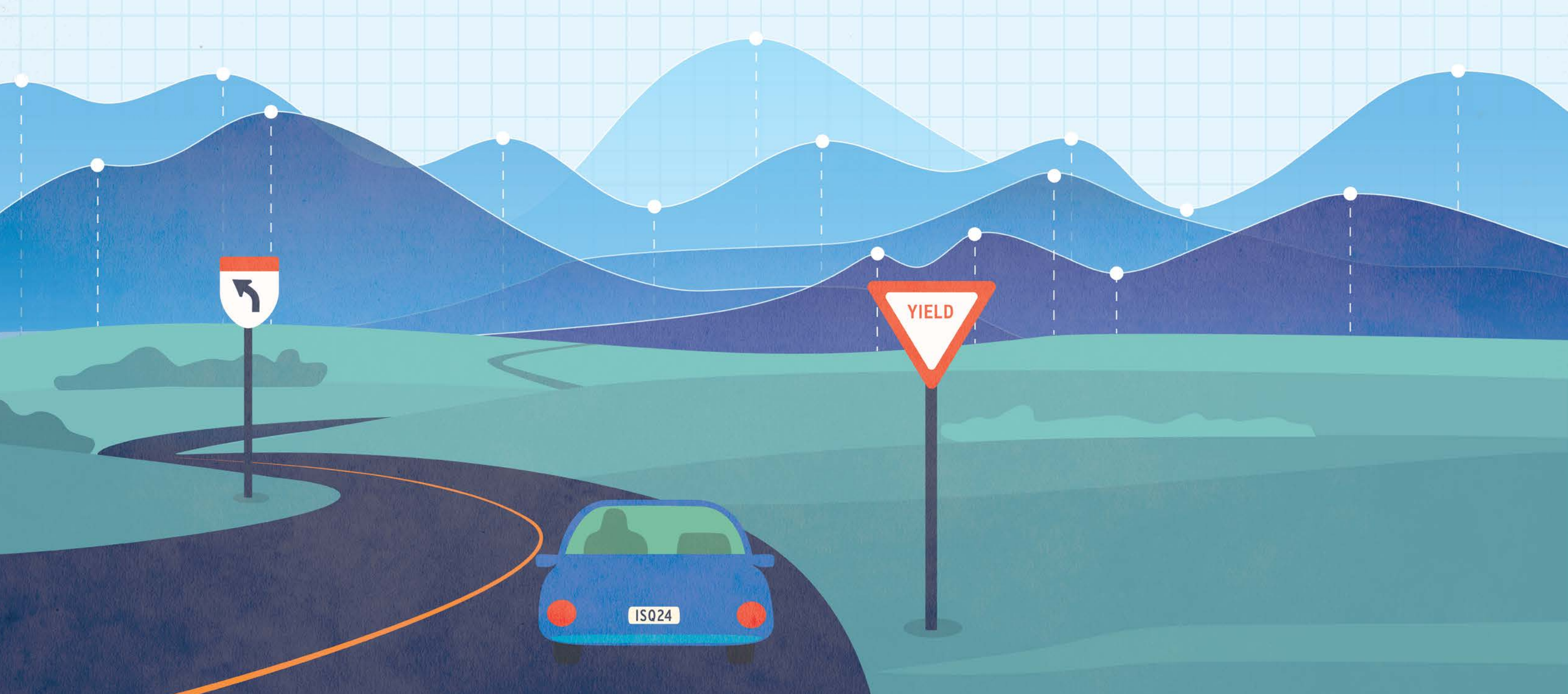
The S&P 500 tends to make up losses and move higher in the year after the election, regardless of who wins.



Source: Bloomberg Finance LP, Data as of 8/30/2024

KEY TAKEAWAYS:

- A series of unprecedented and historic events this summer has completely shifted the dynamics of the race for the presidency and Congress—yet the key issues and likely market impacts of the race remain largely the same.
- Harris' clinching of the nomination has injected enthusiasm into the Democratic base and will likely have down-ballot impacts.
- The reality is the race is likely to come down to a small number of voters in key swing states.
- Historically, while pre-election periods often experience heightened volatility, the first year of a new presidential term typically sees positive market returns, regardless of which party wins the White House.



The Inverted Yield Curve: Still a Reliable Signal?

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

For decades, yield curve inversions have been a closely watched indicator by financial professionals and the media. And there is good reason for that, as inverted yield curves (i.e., when shorter-maturity yields are above longer-maturity yields) have historically served as an early warning sign of an impending recession. In fact, the 2-year to 10-year yield curve has correctly predicted the last six recessions, only giving one false signal in 1998—with a recession typically following 14 months, on average, after the curve first inverts. However, this economic cycle has seen many reliable indicators provide false signals, with the inverted yield curve among them. Below we explore whether the yield curve is providing a false signal this time around and what, if any, implications this may have for investors going forward.

> Inverted yield curves have historically served as an early warning sign of an impending recession.

WHAT DOES THE SHAPE OF THE YIELD CURVE SIGNAL?

Let's take a step back and look at what signal the yield curve is sending to the market. While there are countless yield curve segments to monitor, the most widely quoted yield curve in the financial media is the 2-year to 10-year spread. Under normal circumstances, the shape of the yield curve is positively sloped, meaning that short-term interest rates are lower than long-term interest rates. Positively sloped yield curves signal that the market expects economic growth to expand in the future, with yields on longer-term maturities higher than yields on short-term maturities as investors demand extra compensation for inflation and the potential for future rate increases. Conversely, inverted yield curves signal that economic growth is expected to slow and that interest rates will be lower in the future. Hence, the yield curve captures the market's expectations for growth, inflation and the direction of monetary policy going forward.

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Inverted yield curves also tell you that the Federal Reserve's (Fed's) monetary policy stance is restrictive, as policymakers (who control the front end of the yield curve) are actively seeking to restrain growth and dampen inflation pressures. More important, history has also shown that when the 2-year to 10-year yield curve shifts from its peak inversion point to a positively sloped curve, that has traditionally been one of the strongest signals that a recession is approaching. In fact, a recession has typically followed within two to six months of the curve slope turning positive again. That is why investors are so interested in what comes next, and how best to position their portfolios.

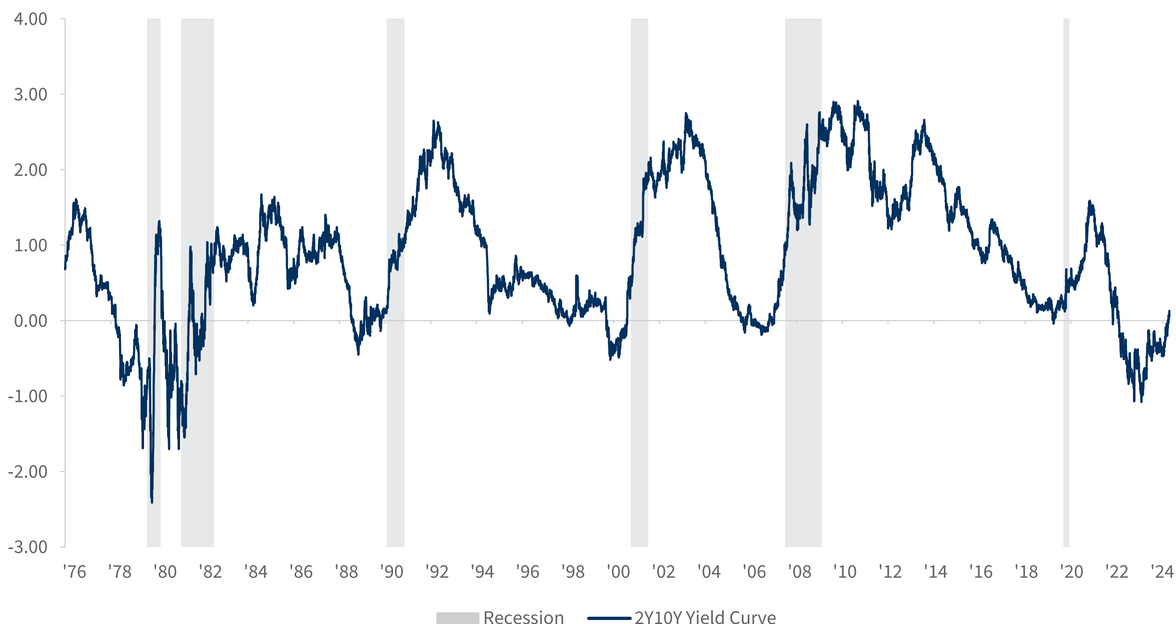
In early September, the 2-year Treasury yield fell below the 10-year yield for the first time since July 2022—ending its longest inversion period in history (547 trading days) since the records began. This is a big move as the 2-year Treasury yield was nearly 100 bps above the 10-year Treasury yield in July 2023 when the Fed delivered its final rate hike after policymakers aggressively raised rates to stamp out inflationary pressures following the reopening of the economy after the pandemic. The return to a positively sloped yield curve is a noteworthy development—as the signal has traditionally put the market on notice that a recession may be approaching. However, it is important to remember that not all segments of the yield curve have normalized at the time of this writing. For example, the 3-month to 10-year yield curve remains deeply inverted (currently -100 bps) as Fed policy remains restrictive. But now that the Fed has kicked off its easing cycle, both curves should steepen, with the 2-year to 10-year spread becoming more positively sloped and the 3-month to 10-year continuing to unwind its inversion. How quickly this occurs will be dictated by how quickly the Fed lowers rates during this easing cycle.

WHY THIS TIME MAY BE DIFFERENT

These words may come back to haunt me, but it does appear that the yield curve is giving a false signal. While the market has been on recession watch for well over two years now, starting just after the US economy recorded two consecutive quarters of negative GDP growth in 2022 and again following the first inversion of the yield curve later that year, there is little on the horizon that

Inverted Yield Curve Historically Predicted Recession

The 2-year/10-year curve was inverted for a record number of days & no recession yet.



Source: FactSet as of 9/23/2024

suggests the economy is at risk of tipping into a recession any time soon. Yes, the economy is slowing, and our economist still expects a modest slowdown in the coming quarters; but barring an exogenous shock, a soft landing remains the most probable outcome. There are several reasons:

1. The economy has been remarkably resilient in the wake of the Fed's most aggressive tightening cycle in forty years. Up until now, weakness in some sectors of the economy (i.e., interest-rate sensitive sectors, such as housing and manufacturing) has largely been offset by strength in other areas. The initial boost of spending on things like travel following the reopening of the economy after the pandemic turbo-charged the recovery. Several rounds of fiscal stimulus in the form of the CHIPS, IRA and Infrastructure Act passed by Congress over the last few years have also boosted growth. Sure, these areas of support could fade, but the point is: the Fed has plenty of fire power at its disposal to lengthen the expansion's runway and fend off any recession risks that arise.

2. While the labor market is cooling, the unemployment rate (at 4.2%) remains low by historical standards even though it has climbed 0.8% since 2023. Thus far, much of the adjustment has come from a slowdown in the pace of hiring, with job growth averaging 114k over the last three months, down from a 196k pace over the last 12 months. The key point: the slowdown in the labor market from its overheated pace has occurred with minimal job losses. And if our economist is right, we should not see any job losses this cycle—that's a big difference versus other cycles.

3. Finally, the Fed did not overtighten. While there is some truth to the old adage that "The Fed will keep raising rates until something breaks"—it has done an exceptional job navigating one of the most challenging economic cycles in modern history. For sure, there have been some growth scares along the way, and we are not fully out of the woods yet—but so far, the Fed's campaign to slow the economy and rein in inflation has done so without plunging the US into a recession.

While the predictive power of the inverted yield curve has waned in this cycle, it does not mean that investors should dismiss the warning signs entirely. That is why we continue to monitor it; but augment our analysis with other fundamental macro signals. And for now, these signals suggest the US economy is on track for a soft landing.

IMPLICATIONS FOR FIXED INCOME INVESTORS

One of the biggest questions on investors' minds, particularly with more than $6 trillion sitting in money market accounts, is whether they should stay invested in cash—which right now, offers a higher yield—or lock in rates further out the curve at attractive, albeit lower yields. As we have noted in the past, Treasury yields have moved significantly lower in anticipation of the Fed's upcoming easing cycle and the scope for further declines from current levels is limited outside of a recession, which is not our base case.

History tells us that cash rarely outperforms bonds once the Fed's easing cycle has begun. However, in cycles in the periods where the 3-month to 10-year Treasury curve was deeply inverted (as it is today) it took about a year or less for Treasurys to outperform cash. This suggests there may still be a small window of opportunity to earn some incremental yield while waiting for further clarity on the pace and magnitude of the Fed's easing cycle. While yields on money market funds remain attractive, it is important to remember that cash rates are only guaranteed overnight. Once the Fed begins its easing cycle, money market yields will immediately adjust lower. In fact, the current rate on a 1-year Treasury bill is just 4.25%—nearly 100 bps lower than today's cash yield, but well above the current 2- and 10-year notes!

For investors who are reluctant to give up the yield advantage of cash, but who are willing to take on additional risk, we recommend they consider investment grade corporates. While spreads are historically tight, all-in yields near 4.7% still remain attractive.

KEY TAKEAWAYS:

- In early September, the 2-year Treasury yield fell below the 10-year yield for the first time since July 2022--ending the longest inversion in history!
- While yield curve inversions have correctly predicted recessions, we think it may be sending a false signal right now.
- History tells us the cash rarely outperforms bond once an easing cycle has begun, but the deep inversion suggests there may be a small window of opportunity.

Investment Strategy Framework

The investment landscape is complex and changing, with multiple factors to consider. Our Investment Strategy Framework ranks the following factors in order of importance to developing our views.

#	Factor	Considerations
1	ECONOMIC GROWTH	• Business cycle (recession/growth) • Employment • Consumer spending
2	FUNDAMENTALS	• Earnings trends • Corporate guidance • Balance sheet strength
3	MONETARY POLICY	• Central bank policy • Impact on US dollar
4	INTEREST RATES & INFLATION	• Borrowing and lending rates • Price pressures • Commodity price trends
5	VALUATIONS	• Price multiples/earnings • Relative value • Spreads/yield curve
6	SENTIMENT	• Consumer, employment, business surveys • Investor attitude/risk appetite • Market expectations
7	CORPORATE ACTIVITY	• Capital expenditures • Dividends/buybacks • Mergers and acquisitions
8	POLITICS	• Regulatory environment • Tax policy and fiscal spending • Trade policy
9	GEOPOLITICAL EVENTS	• Wars, coups, ongoing tensions • Economic and commodity impact
10	NATURAL DISASTERS	• Damage to infrastructure • Disruption of commerce/supply chains

Economic Snapshot

EUGENIO J. ALEMÁN, PhD
Chief Economist

We remain cautiously optimistic about long-term economic growth as it moderates in the second half of the year. However, it is likely to reaccelerate in 2025. Despite a cooling labor market, employment remains positive, and we expect it will stabilize around the long-term average. Consumer spending has weakened, with high prices straining lower-income households the most and pushing delinquencies to the highest level in 12 years. Legislative boosts from the Inflation Reduction Act (IRA) and CHIPS & Science Act have supported business spending in recent times, but as rates start to decline, we expect both nonresidential and residential investment to benefit. Similarly, the manufacturing sector is likely to benefit from lower rates and recover in 2025, while the service sector should continue to remain stable. Geopolitical uncertainty around the world remains elevated, which should be beneficial to the strength of the US dollar.

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	INFLATION	Inflation has continued to come down and is likely to continue its disinflationary trend as economic activity weakens over the next quarters. Shelter costs should continue to slow, and with energy prices negative on a year-over-year basis, inflation should continue to decline.
FAVORABLE	MONETARY POLICY	The Federal Reserve (Fed) started its easing cycle in September, and we expect it to cut rates 50 bps more this year and 100 bps next year. Given this, we anticipate the Fed's terminal rate to be ~3.0%.
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate in the fourth quarter and to reaccelerate in 2025 as the Fed cuts rates.
NEUTRAL	EMPLOYMENT	The labor market has been cooling and we expect it to weaken further and stabilize around its long-term average.
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	MANUFACTURING	The ISM manufacturing index briefly entered expansion territory for the first time since 2022 but returned to contraction shortly after. The sector should start to recover at the end of this year as the Fed starts to ease rates.
NEUTRAL	HOUSING AND RESIDENTIAL CONSTRUCTION	High mortgage rates and rising construction costs have kept this sector in contraction for several quarters, but it has turned the corner. The low supply of homes has kept prices somewhat stable, and lower mortgage rates should propel the housing market further.
NEUTRAL	LONG-TERM INTEREST RATES	The deceleration in inflation, a cooling economy, and rate cuts are all likely to contribute to lower long-term interest rates.
NEUTRAL	FISCAL POLICY	With continued investment through the IRA and CHIPS Act, government spending is likely to remain significant because funds already spent by firms through various fiscal programs will have to be honored.
NEUTRAL	THE DOLLAR	The US dollar's role as a safe-haven currency during times of global instability and expected weaker growth overseas should continue to support the US dollar in the short term.
NEUTRAL	REST OF THE WORLD	We continue to expect a weakening global economy in 2024 despite central banks worldwide turning more dovish.
UNFAVORABLE	CONSUMER SPENDING	Consumer spending has weakened, with lower-income households struggling to pay their credit card bills as higher prices continue to take a toll and the labor market softens.

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.

MIKE PAYNE
Investment Strategy Analyst

These recommendations will be displayed as such:

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	INFORMATION TECHNOLOGY	30.4%	Despite recent volatility in the Tech sector, we maintain our Overweight stance as AI investment should continue to propel earnings going forward. AI-related capital expenditure is expected to remain strong through 2025, which supports first derivative beneficiaries (semiconductors), then monetization should broaden into second derivative beneficiaries (cloud, software applications and hardware devices) in the second half of 2024 into 2025. Any short-term consolidation should be viewed as an opportunity to build positions in this multi-year innovation cycle.
OVERWEIGHT	HEALTH CARE	12.2%	Forward earnings estimates have stabilized and begun to inflect higher after suffering from negative revisions over the last two years driven by post-COVID normalization. The sector's PEG ratio (price/earnings ratio divided by earnings growth) of ~1x is the most attractive of all sectors and Health Care is historically the best performing sector following the first Fed rate cut. Additionally, the sector should benefit from long-term demographic trends (e.g., aging population). Medical devices are an area of strength as the post-COVID inventory normalization appears complete.
OVERWEIGHT	INDUSTRIALS	7.8%	Supportive fiscal spending dynamics (IRA, CHIPS and Science Act, and IIJA), reshoring of global supply chains, and fixed investment in data centers driven by AI should outweigh cyclical headwinds enough to mark an earnings trough in 2024. Our Overweight stance is focused on direct beneficiaries including conglomerates, electrical components, and construction.
OVERWEIGHT	ENERGY	3.2%	With WTI trading below our $75 price target, we believe there's upside to oil prices and the Energy sector over the next twelve months. The sector trades at 13x 2025 earnings with an 8% FCF yield which is already discounting risks of the global economy slowing more than we expect, and the industry disruption from electrification. In addition, shareholder-friendly capital allocation strategies (3.5% dividend yield and 4% buyback yield) should support healthy total returns. Given the steep selloff in the sector and very negative sentiment, this sector call represents contrarian positioning.
MARKET WEIGHT	COMMUNICATION SERVICES	9.6%	The outperformance of Communication Services has been supported by relative earnings strength driven by robust digital ad spend and significant efficiency initiatives. However, the sector has become highly concentrated with mega-cap tech representing ~60% of the segment's market cap. We view mega caps in the Technology sector as better positioned to capture the initial earnings benefit from AI.

	SECTOR	S&P WEIGHT	COMMENTARY
	CONSUMER STAPLES	6.7%	Sales growth within the sector has evaporated to low single digits year-over-year driven by both disinflationary pricing trends and weaker volumes. EPS growth is improving on the heels of easing supply chain and input costs but forward estimates continue to be outpaced by the broader market. We don't see much room for outperformance without material weakness in the broader market which would make the sector's earnings stability more favorable. Our neutral stance on the sector offers more defensive exposure in portfolios if volatility arises while also providing a source of funds to take advantage of any dislocations in markets if they were to arise.
	FINANCIALS	13.1%	The risk/reward dynamic in Financials appears to be balanced leading to our neutral view of the sector. Stable markets and improving CEO confidence should support a gradual recovery in investment banking activity post-election within capital markets and banks along with strength in fee-based revenues within financial services broadly. In banks, keep an eye on rising delinquencies. However, at ~2x book value, valuations within the sector are already discounting a material recovery in fundamentals which creates downside risk if the economy and/or markets weaken further than expected.
UNDERWEIGHT	REAL ESTATE	2.3%	The significant decline in rates following weaker inflation, slowing labor market data, and the Fed pricing in more cuts have led to year-to-date outperformance for this rate-sensitive sector. However, we would not chase this sector to the upside with the 10-year Treasury yield already below our year-end target. Weak earnings trends and ongoing challenges in commercial real estate urge patience with the sector.
UNDERWEIGHT	UTILITIES	2.3%	Despite strong outperformance year-to-date driven by a significant decline in interest rates, we remain Underweight with the 10-year Treasury yield now below our year-end target and overbought conditions in the sector. Balance sheets within the sector are very highly leveraged with very low interest coverage which could create risks in the future that the market is not currently discounting. We prefer Health Care for our defensive exposure which should provide better risk-adjusted returns throughout the cycle.
UNDERWEIGHT	CONSUMER DISCRETIONARY	10.2%	Consumers have begun to push back on elevated pricing throughout most of the sector consistent with our expectations. Firms have responded by lowering prices and focusing on value, which should pressure sales growth and margins in the quarters ahead as consumers become more discerning in their spending. Technology/AI exposure within the broadline retail industry is an area of strength in the sector that we would prioritize.
UNDERWEIGHT	MATERIALS	2.1%	A slowing global economy, particularly in China, should put pressure on the Materials sector. However, valuations relative to the market are trading near historical averages. We'd like to see more attractive valuations properly discounting risks ahead before closing our sector Underweight. There are selective opportunities within construction materials where forward estimates are benefiting from industrial tailwinds.

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.

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. There are additional risks associated with investing in an individual sector, including limited diversification.

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.

This is not a recommendation to purchase or sell the stocks of the companies pictured/mentioned.

Investments in municipal securities may not be appropriate for all investors, particularly those who do not stand to benefit from the tax status of the investment. Municipal bond interest is not subject to federal income tax but may be subject to AMT, state or local taxes.

There are special risks associated with investing with bonds such as interest rate risk, market risk, call risk, prepayment risk, credit risk, reinvestment risk, and unique tax consequences. To learn more about these risks and the suitability of these bonds for you, please contact our office.

The companies engaged in the communications and technology industries are subject to fierce competition and their products and services may be subject to rapid obsolescence.

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