

INVESTMENT STRATEGY QUARTERLY

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Letter from the Chief Investment Officer

The Flag Was Still There

“Our hearts aching, our prayers praying, our flags waving, never forget.” These prescient words spoken by the maker of the American flag, Betsy Ross, are just as true today as they were more than 240 years ago. We ache for those who are suffering from COVID-19, economic hardship, and social injustice. We pray for those protecting and defending liberty and justice for all.

We maintain our belief in the ‘American Dream’ as described by James Truslow Adams, that “life should be better and richer and fuller for everyone, with opportunity for each according to ability or achievement,” regardless of social class or circumstances of birth. We not only acknowledge but embrace that we have work to do as a society, and hope that this year will serve as an inflection point as we advance toward a stronger and more united world.

As tumultuous as times are, we must always **persevere**. And so it is our duty to provide you with our mid-year outlook on the economy and financial markets.

Whether it be wars, pandemics, financial crises, or bubbles **bursting**, the global economy has a history of resiliency, and even in the aftermath of the COVID-19 outbreak, it will be **gleaming** once again. The scale of the global lockdown likely caused the most significant global recession in the post-World War II era. However, it will likely be the shortest recession on record as the **dawn’s early light** of a recovery is signaling a robust rebound in the second half of 2020. Leading indicators and real-time activity metrics suggest the ‘bottom’ occurred in April, as countries eased restrictions, labour market conditions improved and consumer spending was revitalised. Admittedly, the depth of the decline (possibly -35% quarter-over-quarter annualized gross domestic product (GDP) in the second quarter for the United States) means it will take time for any economy to return to pre-COVID-19 GDP levels. For the United States we expect this will not occur until the end of 2021 at the earliest. As a result, our forecast is that US GDP for 2020 will be -5.3% before accelerating to 4.9% in 2021.

Until the recovery is evident from **sea to shining sea**, Congress and the Federal Reserve (Fed) will **make sparks fly** through fiscal and monetary stimulus efforts. The Fed took unprecedented steps to alleviate investor fears, improve credit market functionality, and provide liquidity in order to mitigate

the downside risk to the economy. Fortunately, the Fed has not utilised the newly established programs to their full capacity just yet, so plenty of firepower remains. Similarly, Congress swiftly passed record-breaking levels of direct relief and more could be provided soon, as ongoing negotiations have hinted at additional stimulus in support of the recovery rather than just as an emergency response. The cumulative actions built a pillar of support for the US economy and helped avoid the doomsday scenario.

When fear dominated the financial markets, US Treasuries quickly **earned their stripes** as heightened demand pushed the entire yield curve below 1% for the first time. The realisation of an economic rebound should push yields modestly higher (year-end 10-year Treasury target 1.0%), but the upside will be limited. Despite record issuance by the Treasury in support of the economy, interest from the Fed, foreign buyers, retirees, and institutions should keep demand steady. The Fed followed the lead of other global central banks and expanded the scope of its purchase programs to include investment-grade and municipal bonds, so its ongoing purchases should lead spreads to narrow further. Therefore, we favour these sectors over high-yield bonds (of which global central banks including the Fed are only buying a small portion) which are subject to heightened risk due to the expected uptick in defaults. If investing in the high-yield sector, selectivity will be critical given the high exposure to energy companies and brick-and-mortar retailers, which have arguably suffered the most due to the outbreak.

We **pledge our allegiance** to US equities, which have benefitted from aggressive policymaker action, states reopening their economies, and promising vaccine clinical trials. Despite the recent rally, we remain confident equities will move higher over the next 12 months, surpassing our year-end S&P 500 target of 3,111, as post-recessionary periods have historically been supportive of the equity market. Our bias toward US equities over international equities isn’t based on **patriotism**.

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Much of Europe participated in coordinated fiscal stimulus action, but US economic growth will be more resilient and the rebound should be much more robust. In addition, the sector composition of the S&P 500 is more apt to weather a potential second wave in COVID-19 cases while simultaneously being better positioned to thrive should the economy accelerate as expected. We still favour more cyclical or growth-oriented sectors such as Technology, Communication Services, and Health Care. For long-term investors wanting international exposure, we would consider select Asian emerging market equities as they may benefit from our expectations of a global recovery, a modestly weakening US dollar, and attractive valuations.

Oil prices remain **at the liberty of** global demand, which will normalise as economies across the globe reopen. The demand fallout from COVID-19 peaked at ~20+ million barrels per day (bpd) earlier this year, but should ease to 5 and 1.25 million bpd in 2021 and 2022, respectively. Prices will also benefit from production cut agreements between OPEC and Russia as they attempt to reduce global oil supply by ~10%, and from the decline in US production due to a reduction in capital expenditures and new wells. With both the demand and supply side of the equation improving, oil prices should end the year around \$38 per barrel.

The panic-driven market movements caused by COVID-19 have been subdued, but pullbacks remain possible and should be viewed as a natural, healthy occurrence. We are monitoring the potential risks **o'er the ramparts**, especially since equity valuations are the highest since 2001 and due to the tremendous amount of optimism priced into the market. The upcoming election is poised to be a **perilous fight** as the virus-induced recession has altered President Trump's reelection prospects.

No president has won reelection when a recession coincided with the election year, and with the possibility of a Democratic sweep on the rise, the market's concern for a rollback of the corporate tax cuts may become elevated. In addition, escalating tensions between the US and China have renewed fears surrounding a derailment of the trade truce, and any potential setback in the development of a vaccine could curtail investor confidence as we seek to emerge from this ongoing health crisis.

The original **Star-Spangled Banner** is on display at the Smithsonian's National Museum of American History as it encompasses the values on which the American nation was founded: freedom, justice, and equality. Throughout history these values have been tested, and they have always endured. From an investment strategy perspective, this is not the first year investors have faced challenges and it will surely not be the last. However, it is times such as these that prove the principles of asset allocation and selectivity are indeed a **perfect union** that can help your portfolio stand the test of time. The **stars of the flag** are located in the 'northwest quadrant' when properly flown or hung, and portfolios should strive to move toward this quadrant too – a place that maximises return for a given amount of risk.

Have a safe, healthy and enjoyable summer. ■



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What Awaits the U.K. Economy and Markets in H2 2020?

Chris Bailey, *European Strategist*, Raymond James Investment Services

After a tumultuous first half of the year, thoughts about the next six months must at first be centred on the risks of repeat volatility. Recent weeks have seen lockdown life exhibit a slow liberalisation across the U.K. as immediate pandemic concerns moderate. Patently it is still not easy out there and maturing government wage support schemes, a concern from many consumers whether or not to spend money, and a business environment backdrop where entrepreneurs are uncertain whether to take risks and commit to investments, will linger over the rest of the year and into 2021.

The latest regular survey of global money managers published in mid-June highlighted that a majority of respondents were still very cautious about the future for all the reasons cited above. And judging by material underweight holding in U.K. equities versus benchmark by the average global investor, concern about our own country runs deep. Undoubtedly, this will be partially influenced by the terribly sad aggregate pandemic cases and death rates, but it is also influenced by other matters that more typically impact financial markets. After all, recent disclosures about U.K. GDP has suggested an annual decline for 2020 at levels not seen in over three hundred years. Meanwhile,

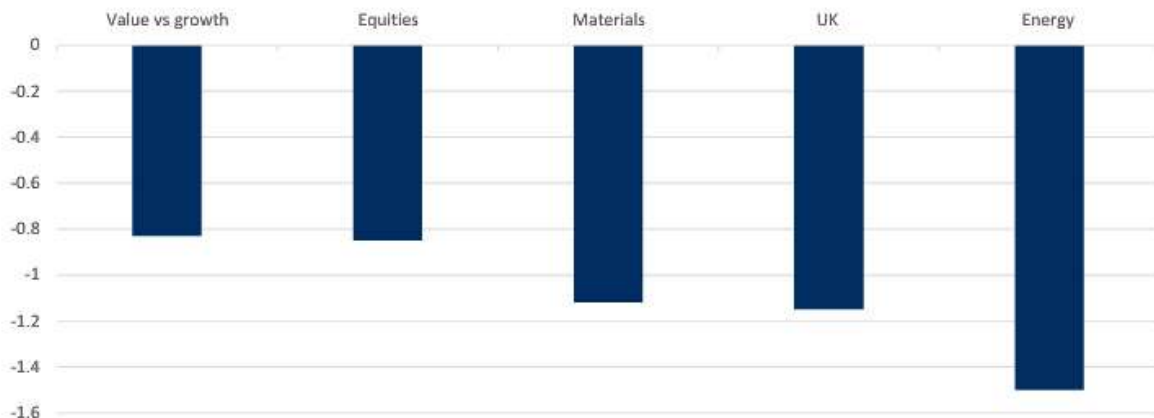
Let not your mind run on what you lack as much as on what you have already - *Marcus Aurelius*

borrowing levels are at proportions of national output last hit in the couple of decades after World War Two. As for the Brexit debate, the legislative deal struck in January feels a long time ago and precious little progress has been made on the required detailed trade deal.

Such caution and pessimism does not sit well with a normally positive default position towards both human progress and human ingenuity over time. Certainly, the undeniably fallible human race can surprisingly easily get caught up in a short-term cycle of uncertainty and despair. Financial markets are similarly swayed over shorter time periods by such psychological and behavioural traits, hence the volatility of the first half of the year and the underperformance of U.K. equity assets, as well as a lacklustre time for the pound.

There is little doubt that U.K. risk assets are as bound up with global events as they are with domestic-driven realities. The U.K. is an open economy highly influenced by the level of global commerce and travel. Meanwhile, the composition of the larger capitalisation elements of the U.K. equity market is from a sector

Bottom five allocation areas in the June Fund Manager Survey



Source: Bank of America Fund Manager Survey

basis biased towards global earners of both a cyclical and more defensive nature. Exposure to the technological sub-sector areas which have enthused many global investors recently is more modest. Overall, this makes the U.K. economy, equity market and - by extension - the Pound geared towards any general global and domestic recovery. Progress seen in both East Asia and the Eurozone over recent months in controlling the impact of the first pandemic wave and hence allowing a broader restarting of economies, will help.

However this needs to be supplemented by some heavy lifting domestically, beyond the use of the Bank of England's balance sheet and the government's budget deficit. It is probably a good sign that the senior officers of the Bank of England have recently stepped away from the notion of negative interest rates. For the future credibility of monetary policy, this is a positive step as negative interest rates are no panacea, as reflected by the recent experience of the Bank of Japan and the European Central Bank. Despite some 2020 outlook forecasting improvements from the U.K.'s central bank, the negative economic impact still anticipated in this year will dwarf anything seen in recent generations in speed and magnitude, and will not be fully offset in 2021. This is why the maintenance of an extremely loose monetary policy backdrop will persist deeper into the 2020s.

Fixed income markets are being remarkably acquiescent of the big build up in fiscal deficits to fund wage support schemes and other government spending initiatives. Partially, this reflects heightened quantitative easing purchasing by the Bank of England, as well as negligible immediate inflationary threats and naturally muted multi-year economic growth levels. However such an easy absorbing of material deficits cannot be taken for granted.

And this is where encouraging innovative thinking comes in, akin to the Prime Minister's recent assertion to 'build, build, build'. The key to a sustainable recovery outside of confidence in the health backdrop, is centred on encouraging everyone in the

economy to think pragmatically and from an entrepreneurial perspective. Forget what has gone, think more about what you can do. Specifically in the U.K. there were hints after the last election of a bunch of 'one nation' reforms which have disappeared off the airwaves for obvious reasons in the last few months. It is essential to see initiatives like this - cutting across individuals and companies alike - coming back to fill the void that the inevitable tapering of wage and business support schemes will induce.

And finally, one of the biggest contributions to achieving such a backdrop over the next few quarters is avoiding a messy Brexit trade deal finale. Brexit retains its politically provocative capabilities but, shorter-term, avoiding additional economic growth challenges is a must. Expect a series of compromises here during the second half of the year, and a broader realisation that simple geographic proximity and ongoing inherently high trade links is reality.

Plenty of challenges await but some common sense at both the healthcare and economic policy level will mean that U.K. risk assets - especially equities and the Pound - will provide opportunities for investors in the second half of the year and beyond, hopefully at substantially lower levels of volatility than seen in the first six months of the year. ■

KEY TAKEAWAYS:

- Recent weeks have seen immediate pandemic concerns in the U.K. moderate, but patently the backdrop is far from easy.
- U.K. risk assets are as bound up with global events as they are with domestic-driven realities.
- Expect the maintenance of an extremely loose monetary policy backdrop.



U.S. Economic Outlook – A Strong Initial Rebound and Then...?

Scott J. Brown, PhD, *Chief Economist, Raymond James*

Efforts to contain the spread of SARS-Cov2, the strain of coronavirus that causes COVID-19, led to an unprecedented decline in US economic activity this spring. As states have relaxed social distancing guidelines, growth has picked up sharply, also on an unprecedented scale. However, the initial rebound will leave us far short of where we started the year and there is a lot of uncertainty about the virus and the future availability of a vaccine or effective treatment against it. A full recovery will take time.

Social distancing had a major impact on several sectors of the economy, notably air travel, hotels, restaurants, retail, spectator events, and healthcare – anything where one would come into close contact with other people. Job losses in these sectors have been massive. The leisure and hospitality sector lost half of its jobs between February and April. A key concern was whether that economic weakness would snowball – that the corresponding loss of wage income would lead to further reductions in consumer spending. That spending is someone else's income. However, second-round effects have appeared to be relatively limited thanks to government aid.

The fiscal support was as unprecedented as the downturn itself. More will likely be needed.

FISCAL STIMULUS SHORES UP THE SYSTEM

Federal support has played a key role in countering the economic effects of the pandemic. Increased spending on healthcare was critical in treating the infected. 'Recovery rebate' checks and expanded unemployment insurance benefits helped to shore up household income. Lending to small businesses kept many firms operating. Federal aid to the states offset strains in state and local government budgets.

The fiscal support was as unprecedented as the downturn itself. More will likely be needed. Extended unemployment benefits are set to run out at the end of July. State and local budget strains will worsen amid falling revenues and recession-related spending increases. The first three phases amounted to nearly \$3 trillion, over 14% of gross domestic product (GDP). Bear in mind that the deficit was running at over \$1 trillion per year prior to the pandemic, with the economy near full employment.

The Fed's balance sheet increased almost two-fold as a result of stimulus measures such as the CARES Act.



The Federal Reserve's (Fed) response to the pandemic was quick and forceful. The Fed cut short-term interest rates to effectively zero in early March and restarted asset purchases ('quantitative easing'). It relaunched liquidity and lending facilities that it had employed during the financial crisis and created some new ones. The size of the Fed's balance sheet rose from around \$4.2 trillion in late February to \$7.1 trillion at the end of June.

pandemic, lawmakers will have to work to bring the deficit in line. That doesn't mean balancing the budget. Rather, we should try to have the national debt stable or falling as a percent of GDP over time. Lower deficits will require higher taxes, cuts to entitlement and other spending programs, or some combination. However, there is no rush. The bigger dangers are not doing enough to back up the economy in the near term and ending support too soon. Budget austerity may have broad political support, but it would make the recovery weaker.

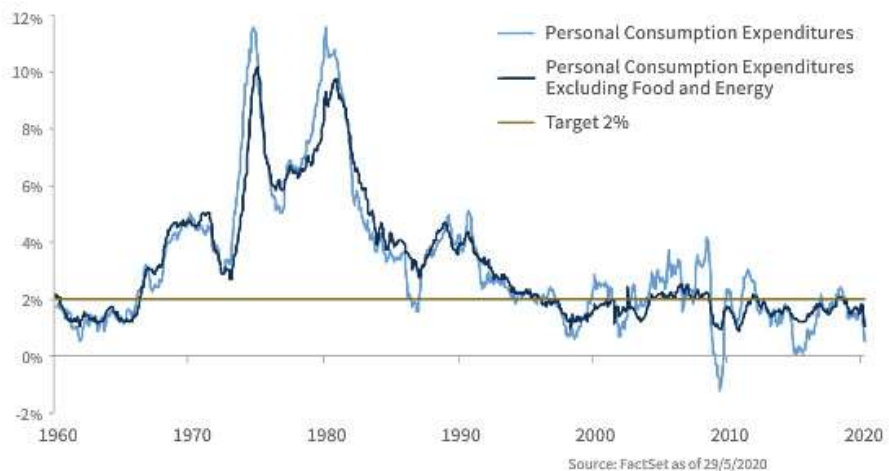
BUDGET DEFICITS AND INFLATION

Many investors are concerned about the government's ability to repay the additional borrowing. However, the government is nothing like a household. The government only has to make interest payments and be able to roll over maturing debt. That's not a problem currently. Interest rates are low and are expected to remain so over the long term. While the federal government has been borrowing more in the near term, the Fed has increased its holdings of Treasury securities. Private savings have increased and the demand for safe assets is strong.

Some investors worry that the Fed's efforts will fuel higher inflation. This is the same concern that was expressed during the financial crisis. Inflation is a monetary phenomenon.

Still, the federal budget was on an unsustainable path before the pandemic. Federal debt was rising as a percent of GDP. At some point, beyond the

Inflation Remains Below Target



“ The bigger dangers are not doing enough to back up the economy in the near term and ending support too soon.”

Yet, the relationships between growth, inflation, and the money supply broke down in the early 1990s. For the most part, the Fed views inflation as driven by inflation expectations and pressures in resource markets – capital, labour, and raw materials. Following the great inflation of the 1970s and early 1980s, the Fed spent decades establishing its credibility as an inflation fighter and was perhaps a little too successful in keeping inflation low. It has struggled to achieve its 2% inflation goal over the last several years. Importantly, the Fed and other central banks around the world have not abandoned their inflation goals. There is no conspiracy to monetise the debt.

The pandemic has shifted from a supply shock to a demand shock. There is excess productive capacity globally. While there may be some bottleneck inflation pressures as economies around the world begin to recover and supply chains are adjusted, significant inflation pressures in capital and raw materials are unlikely. In the US, the labour market is the widest channel for inflation. Labour cost pressures are expected to be mixed, but generally moderate. In the near term, high unemployment should keep wage increases in check, although job losses have been highest at the low end where there wasn't much pressure to begin with.

RECESSION AND RECOVERY

The recession began in February and may have ended in April or May. That would be the shortest downturn on record. That doesn't mean that the economy has recovered; it simply means that the economy began growing again. As the downturn was unprecedentedly large and swift, the initial rebound will be exceptionally strong and investors have eagerly embraced that view. Economists expect that third quarter GDP growth will be the strongest ever recorded, led by a sharp rebound in consumer spending. With the ability to spend limited in the downturn, savings improved, and that should fuel spending in the near term. However, the initial rebound will leave the level of GDP far below where it was at the end of 2019.

Looking ahead, the pace of recovery will depend on the virus and efforts to contain it, but it will likely be several quarters before GDP returns to its pre-pandemic level.

It will take the economy even longer for GDP to get back to its previous trend. Absent a vaccine or effective treatment, the sectors affected most by social distancing can be expected to recover gradually. We could have some luck with the development of a vaccine, but risks to the outlook into next year appear predominately to the downside.

One fear is that reopening the economy too soon raises the risk of a second wave of infections and a more prolonged period of social distancing. More likely, the US has implicitly settled on a trade-off between economic activity and a moderate pace of new infections and deaths.

Severe recessions usually leave long-lasting impacts on economic activity. Consumer behavior and global trade are unlikely to return to previous patterns. While the recent improvement in the economy is welcome, there will be significant long-term damage in some sectors. As Fed Chair Powell noted, the coronavirus has taken a human and economic toll and “the burden has fallen most heavily on those least able to bear it.”

KEY TAKEAWAYS:

- As states have relaxed social distancing guidelines, growth has picked up sharply.
- Federal support has played a key role in countering the economic effects of the pandemic.
- The recession began in February and may have ended in April or May – the shortest on record. That just means that the economy began growing again, it doesn't mean that the economy has recovered.
- The pace of recovery will depend on the virus and efforts to contain it, but it will likely be several quarters before GDP returns to its pre-pandemic level.



Where Next for the Eurozone?

Chris Bailey, *European Strategist*, Raymond James Investment Services

The Eurozone has not had an easy last ten years, buffeted between internal discord, sluggish growth and strained diplomatic relations with Russia, the U.K. and the United States. Whilst certain regional companies remain world leaders, regional stock markets have typically lagged global benchmarks and the sustained policy of negative interest rates by the European Central Bank (ECB) appears further away from a conclusion than ever.

Despite this unpromising backdrop, the pandemic crisis tentatively has caused a rethinking of previous orthodoxies and hardened negotiating instincts. And whilst the heavy toll across families and broader populations throughout all western European countries - but especially Italy and Spain - will not be forgotten, the crisis of yet another period of economic growth challenge has led to some surprising reactions.

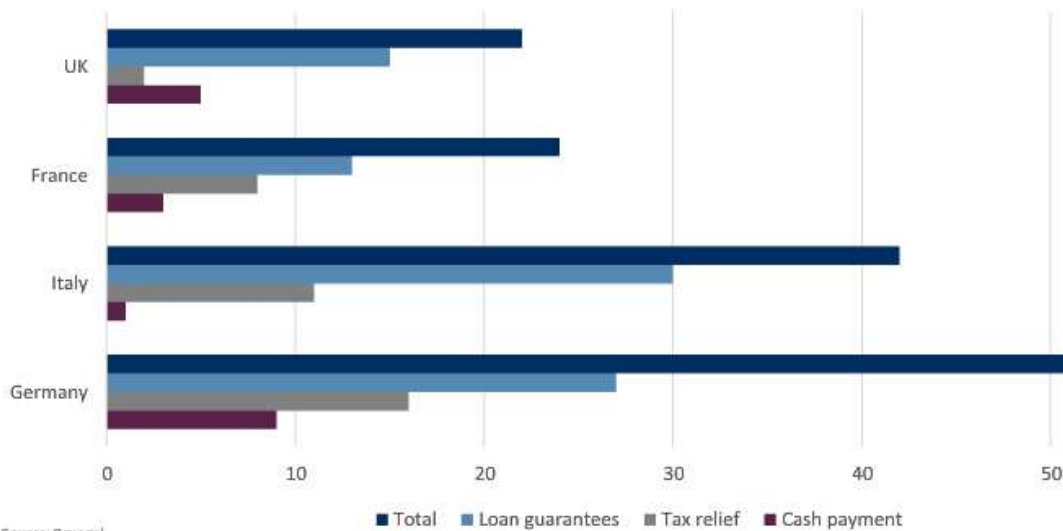
Christine Lagarde's first few weeks as President of the ECB did not get off to a particularly smooth start, with a fumbled answer about sovereign bond spreads in her inaugural press conference inducing volatility in the deeply influential Italian bond market. Lagarde's years as head of the International Monetary Fund, however, put her in a good position to both help forge compromises and respond to a burgeoning crisis by further heightening and extending the central bank's quantitative easing policies.

In the midst of every crisis, lies great opportunity -
Albert Einstein

So far, so textbook. The Eurozone's problems have never been with its central bank since the previous president Mario Draghi's 'whatever it takes' Damascene conversion. Such willingness to embrace an extended balance sheet has created powerful enemies over the years. Whilst the German Bundesbank maintained a policy of tentative and mild support at best, the country's Constitutional Court materially upped the ante in May by calling the ECB's bond-buying powers into question.

It goes without saying that this was at face value extremely unhelpful. However, acute observers would have noted at the time the frustration towards the court espoused by German Chancellor Angela Merkel, whose final years of direct political power have been riven with challenges. Last autumn my own conclusion was that the impending chancellorship election due two-thirds of the way through 2021 would induce her own Damascene conversion to a world of legacy enhancing unbalanced fiscal budgets. The conclusion was correct, but the transmission mechanism to get there was very, very different.

Government support as a percentage of GDP



Possibly influenced by her own scientific background but certainly backed by an efficient and effective administration, the German pandemic response has impressed many neutral observers. Looking beyond the bald healthcare numbers and statistics, Germany was also most proportionately responsive in areas such as loans and associated financing opportunities to business to tide them over the pandemic period. Certainly, there is something about a truly exogenous crisis such as the COVID-19 pandemic that highlights, even to a country that prides itself on business efficiency and high productivity, that material assistance - even of an anticipated temporary nature - is required. Supplement this with the costs of a wage support scheme and Germany's very orthodox balanced budget position had shifted, at least temporarily, to a material deficit position.

Contrary to the instincts of many arch Euro-sceptics, the really big heavy lifting fiscally across Europe is still undertaken by the national governments. Unsurprisingly, the crisis has produced a slew of national government fiscal initiatives boosting budget deficits to levels that would have provoked anger and sanctions at previous crisis times in the Eurozone. At this time, supplemented by the ECB's continued efforts, these are being funded at strikingly low bond yields. Whilst this may appear to reflect a coordinated monetary and fiscal policy, the dearth of a central fiscal lever sourced straight out of Brussels and used as a supplementary fiscal boosting tool in the most impacted parts of the whole Eurozone, was missing. Such pan-regional fiscal rebalancing is a function of all successful monetary unions

(for example the United States). Recent weeks have seen plans and actions - led by Angela Merkel - to forge the first of these instruments. With Germany holding the rotating presidency of the Council of the European Union until the end of 2020, there has never been a clearer opportunity to push the button on such an initiative. Again, this is no panacea, but it reflects both the Eurozone and the European Union continuing to grow up. It is just a shame that it took such a crisis to open up such a potential policy shift.

Meanwhile, for asset allocation experts whose default position has been to underweight both the region's financial markets and the Euro, it should induce a reassessment. 'In the midst of every crisis, lies great opportunity'.

KEY TAKEAWAYS:

- The pandemic crisis tentatively has caused a rethinking of previous orthodoxies and hardened negotiating instincts.
- Influential has been Germany's shift from a balanced budget position to, at least temporarily, a material deficit position.
- There has never been a clearer opportunity to push the button on a pan-regional fiscal policy initiative.
- Such a policy could induce a reassessment from global asset allocation specialists to the region's financial markets and the Euro.



Oil Prices Set for Recovery into 2021 and Beyond

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

It is a good bet that none of us will ever forget seeing West Texas Intermediate (WTI) oil prices at a negative \$30 per barrel. Was that the bottom? In a word: Yes. The extraordinary sight of negative pricing marked the worst of the COVID-19 pandemic's impact on global oil demand. While sub-zero prices are unlikely to be repeated, that does not mean that it will be all smooth sailing from here on out. Demand recovery to pre-COVID-19 levels is unrealistic until 2022, so supply will need to play a key role in rebalancing the market.

NEGATIVE OIL PRICES?

First, about those negative prices. That was a very short-lived phenomenon – just a few days in mid-April – and, to clarify, it was specific to WTI. WTI, the price most US investors see, is not always indicative of global oil market fundamentals. In April, the overall oil market panic was compounded by a WTI-specific issue: storage in Cushing, Oklahoma (where WTI contracts are priced) was reaching capacity. This is what's called oil-on-oil competition: literally, not enough room to put the extra barrels. Internationally, while the oil market was also under intense stress, prices did not go negative, because the storage issues were less pressing. We do not envision a return to negative prices, but if it were to happen again, investors should focus on Brent – the global benchmark – rather than WTI.

The demand picture into the second half of 2020 should continue to improve, ... but it would not be realistic for demand to fully normalize in 2021.

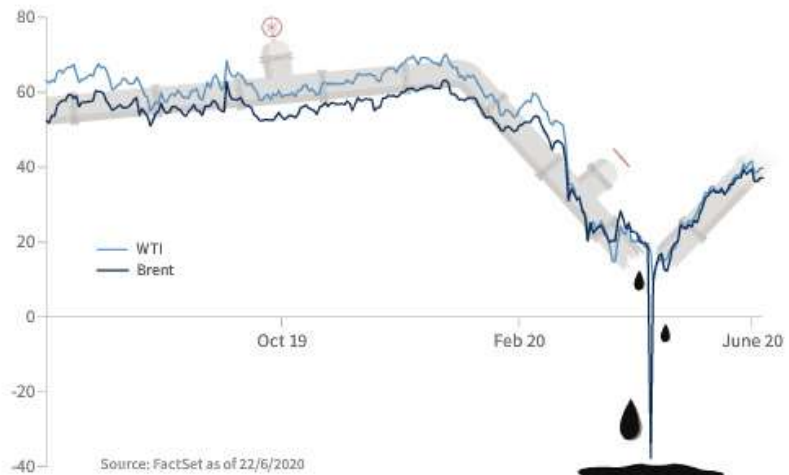
SUPPLY AND DEMAND

We believe that the worst of COVID-19's demand impact is in the rearview mirror, having peaked in April at upwards of 20 million barrels per day (bpd). The initial recovery since then reflects, above all, the timing of economic reopening decisions by governments. We have been tracking reopening policies in 80 countries, and here is the synopsis: of the 4.3 billion people who have been under a lockdown at some point since January, over 99% have some reopening, including 80% with what we define as reopening concluded. At this point, further reopening is purely a matter of 'depth' rather than 'breadth', whether using a sectoral approach or along regional lines. The positive read-through for transportation activity is confirmed by traffic congestion data, as well as commentary by refiners and other energy companies during the recently concluded reporting season.

The demand picture into the second half of 2020 should continue to improve as the various countries move along their reopening roadmaps, but it would not be realistic for demand

Domestic vs. International Oil Prices

“WTI, the price most US investors see, is not always indicative of global oil market fundamentals.”



to fully normalize in 2021. Not only will demand in 2021 still be affected by the post-crisis economic damage (high unemployment, business bankruptcies, etc.), but the pandemic has also caused a structural shift in travel patterns around the world. This includes more telecommuting and distance learning, as well as less travel (especially less flying) for both leisure and business purposes. In the absence of a vaccine, the way many people think about the health risk of getting on planes, cruise ships, or even buses will remain problematic. Gauging consumer psychology is more art than science, but our current assumption is that COVID-19's impact will be 5 million bpd in 2021, disproportionately in aviation. For 2022 and beyond, assuming a vaccine is widely available by that point, thereby enabling a reversion in travel patterns to something closer to pre-COVID-19 levels, we think the impact will diminish to 1.25 million bpd.

Alongside the recovery in demand, the production cuts being implemented by OPEC and Russia are also helping to bring the global supply/demand situation into balance. These cuts took effect in May and the plan is for them to continue, at gradually decreasing levels, into 2022. Even more importantly, drastic cutbacks in the oil industry's capital spending will weigh on global oil supply for years to come. Capital spending in 2020 is below its previous (2016) trough, and nowhere has it fallen more sharply than in the US. At current oil prices, there is no way to avoid US production continuing to fall through all of 2021 and 2022. The industry would simply not be able to generate sufficient cash flow to enable spending to recover to maintenance levels, to say nothing of resuming growth. In addition to the US, other countries where organic field declines are likely to be hefty include China, Mexico, and Colombia.

To prevent drawdowns in global oil inventories from reaching unsustainably steep levels (thus leading to a future shortage), oil price recovery will need to be more robust, as well as more rapid, than what is implied by commodity futures. With the caveat that the level of uncertainty – for both demand and supply – has probably never been higher than it is currently, we forecast WTI prices recovering to \$38 per barrel in 4Q20 and \$50 as the average for 2021. For 2022 and beyond, our long-term assumption is \$65. ■

KEY TAKEAWAYS:

- We do not envision a return to negative prices, but if it were to happen again, investors should focus on Brent – the global benchmark – rather than WTI.
- The demand picture into the second half of 2020 should continue to improve as the various countries move along their reopening roadmaps, but it would not be realistic for demand to fully normalize in 2021.
- Alongside the recovery in demand, the production cuts being implemented by OPEC and Russia are also helping to bring the global supply/demand situation into balance. These cuts took effect in May and the plan is for them to continue, at gradually decreasing levels, into 2022.



Fragile Truce on the Brink: Why China Remains a Major 2020 Theme

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

The year began with the signing of a 'Phase One' economic and trade agreement between the US and China which was set to provide President Trump with a significant win backing up a strong economy heading into his reelection campaign. However, as we have seen in most other areas, the spread of COVID-19 and the associated economic disruption shifted the dynamics of the relationship between the US and China in a major way.

Importantly, the Trump administration's China 'hawks' are now clearly driving the agenda, as evidenced in the recent uptick in administration policies challenging China in an increasingly broad manner. Particularly, US/China tensions are notably rising in the areas of technology (next-gen 5G networks and advanced computing) and capital markets, which will be leading themes for the rest of 2020 and beyond. The tensions are also becoming increasingly geopolitical in nature, as we have seen in questions over the future of Hong Kong and Taiwan.

Looking to the future, we will be keeping a close eye on two factors which will play a large role in the US/China dynamic in the coming months: the scope and pace of the US economic recovery, and political messaging leading up to the November elections.

... we could see some relaxation of tariffs, as a way to relieve economic pressures and support recovery.

We expect the election campaign to entrench negative public sentiment against China for the foreseeable future and become a key campaign issue for both President Trump and former Vice President Biden. Furthermore, a faster than anticipated economic recovery along the lines of the bounce back we have seen in the market could embolden President Trump to take more aggressive actions against China, as we have seen throughout the trade fight of 2017-2019. Throughout this, market attention will focus on the threat of the Phase One trade deal collapsing. Although we anticipate escalating tensions could lead to threats to pull out of the deal by either side, the economic relationship may prove to be an important area of cooperation in order for the two sides to maintain dialogue during a fragile global economic recovery.

PRESSURE ON CHINA INCREASINGLY BIPARTISAN ACROSS THE GOVERNMENT

In the wake of COVID-19's disruption in the US, we have seen a more unified effort across the government to increase pressure on China. A variety of notable actions have come from the White House, Congress, and federal agencies increasing pressure on

By the Numbers

5

Actions and regulations by federal agencies to limit China's access to US technology/software

4

US government actions to increase pressure on China's human rights record

3

US government actions to scrutinize China's access to US capital markets

2

Major bills in Congress to assign damages to China for the spread of COVID-19

1

US Election

China in areas such as technology, capital markets, human rights, and supply chain security. The increased pace of these actions matches the war of words between the two nations which has escalated over China's role in the global spread of COVID-19.

In our view, the most impactful of these efforts will be limiting access to US technology and software to China's leading technology companies and increasing scrutiny on China's access to US capital markets. The tech war dramatically escalated this spring, and the conditions for a longer-term 'Tech Cold War' are solidifying, causing the US and China to compete over primacy in the space of next-gen networks and technologies. Pressure is also building on capital market ties between the US and China. The Trump administration successfully pushed back on the government retirement savings fund transitioning part of its portfolio to Chinese equities, and there is a high likelihood of Congress enacting a law that would force Chinese equities to delist from US stock exchanges if they do not meet certain auditing standards. In all, these two pressure points are likely to be long-term trends, regardless of the administration in power following the 2020 elections.

IMPACT OF THE 2020 CAMPAIGN

We are often asked why this bipartisan push against China exists and whether a potential Biden administration would walk back some of the hardline approach of the Trump administration. I always go back to one of the first lessons I learned as a young Capitol Hill staffer – "In politics, when you are explaining, you are losing." For members of Congress, they have a choice of which team they want to be on: Team China or Team USA. This is not a difficult political choice and we see this playing out on Capitol Hill where members only challenge President Trump with proposals to go even further than he has in confronting China.

This dynamic will limit the extent to which there can be an alternative view with regard to the US relationship with China, particularly given the spread of COVID-19. This election is likely to be one where both Republicans and Democrats will have to take a tough line on China and explain how they plan to hold China accountable for the narrative forming around China's lack of effective information sharing and containment on COVID-19. Further, given that a significant portion of this year's legislative

action has been stifled by the spread of the virus, candidates will lean more on their China policy as a demonstration of actions they've taken during their time in office while making their reelection pitch. This is likely to entrench an overall negative view of China for a significant period.

It is also worth noting that an expanded scope of frictions between the two nations, particularly in an election year where rhetoric will be consistently elevated against China, limits opportunities to find off-ramps to de-escalate. This increases the overall risk of miscalculation on critical matters. Although the two sides are appearing to separate out the recent disputes in order to maintain general economic cooperation, the risks are rising of a spiraling confrontation. Alternatively, the economic relationship may prove to be an important area of cooperation for the two sides to continue a dialogue and maintain general global economic stability at a fragile time. Should Biden win the presidency in November, we could see some de-escalation, but far from a complete thaw. We believe a Biden presidency would seek to reestablish traditional post-World War II global alliances that have been impacted by the Trump presidency. Should that occur, walking back on China would likely not be a top priority. However, we could see some relaxation of tariffs as a way to relieve economic pressures and support recovery. ■

KEY TAKEAWAYS:

- The spread of COVID-19 and the associated economic disruption shifted the dynamics of the relationship between the US and China in a major way.
- The Trump administration's China 'hawks' are now clearly driving the agenda, as evidenced in the recent uptick in administration policies challenging China in an increasingly broad manner.
- A variety of notable actions have come from the White House, Congress, and federal agencies increasing pressure on China in areas such as technology, capital markets, human rights, and supply chain security.
- The economic relationship may prove to be an important area of cooperation for the two sides to continue dialogue and maintain general global economic stability at a fragile time.



The Burden of Debt

Chris Bailey, *European Strategist*, Raymond James Investment Services

Partially due to government fiscal responses to the COVID-19 pandemic challenge, global debt levels are growing. Gross government debt issuance is currently running at over two trillion U.S. dollars a month, more than double the 2017-19 average of just shy of a trillion dollars. Meanwhile, the International Monetary Fund (IMF) warned last month in their most recent World Economic Outlook publication that 'elevated debt levels...could constrain the scope of further fiscal support - and will pose an important medium-term challenge for many countries'.

And yet global sovereign bond yields typically remain exceptionally muted. Looking at benchmark ten year government paper, for major developed market economies only Italy and South Korea yield over 1% (and in both cases only modestly so). Germany, France and the Netherlands will even offer you a negative yield. And all these numbers in real terms after inflation are even lower.

As every mortgage borrower knows, the rate of interest charged on debt does matter. Looking at the above, there appears to be an almost riskless payoff for borrowing more money. However, just when you think it is safe to go back into the water...

The first key for the maintenance of this strange backdrop is global quantitative easing by the world's major central banks. Drawing on the laws of supply and demand, if a big player such

Rather go to bed without dinner than to rise in debt -
Benjamin Franklin

as a central bank keeps on printing money to buy government bonds, the scope for bond yields to get chased down can be apparent. Certainly the world of the last eleven years has seen plenty of evidence of this.

As it happens, compressed bond yields via quantitative easing purchasing go back much further than this. Japan has been an unusual fixed income market over more than twenty years. Not only has there been a deep and regular flow sourced from the high savings rates of the local populace but government direct participation in the fixed income markets has frequently seized up the Japanese government bond market. Volatility for practitioners has been remarkably low but there has been liquidity trade-offs. And in such a world the reliance on that regular flow of savings is important, otherwise the risk is an ultimate lack of central bank credibility including potential inflationary consequences. My instinct is that Japanification is not as easy as it sounds for countries in Europe and the Americas, let alone what it implies for the economic growth backdrop.

Benjamin Franklin's instincts are undoubtedly correct in a binary choice but in practical policy terms there are three broad policy initiatives a government can enact to counter a build-up in their public debt burden - and these have not changed since classical times.



Source: Doblin's Innovation Wheel; Visual Capitalist

The first and best response to public debt is to grow and innovate. This is what happened after the Second World War, when debt levels in the U.K. were notably higher than even today's 100 per cent of GDP. Simply put, growing GDP proportionately faster than the at-the-margin interest burden proportional increase will contract debt over time. And whilst much analysis in economic history has been focused on the factors of production (land, labour, capital and entrepreneurial nous), the reality in today's complex and competitive world is that it centres on innovation. Boost innovative capabilities and hence economic growth to reduce your debt burden. This is after all one reason why China has such a large focus on supply-side change and evolution. A degree of fiscal prudence is required too as the Benjamin Franklin quote attests but - as the old business saying goes - you cannot cut your way to success. Slower growth countries in southern Europe such as Italy and Greece may be enjoying the lower yields on their material debt burdens today thanks to material European Central Bank quantitative easing support, but it is no ultimate solution.

Greece provides a nice segue into another policy option: default. In today's world this typically evolves into a bond 'haircut' (a reduction or maturity extension of anticipated coupon or principal repayments) and certainly a wide range of Greek bond holders faced such a reality a few years ago at the height of the country's debt struggles. Unsurprisingly, it is a policy to only use in extreme circumstances as even with central bank support, lenders can have long memories. The growth contractions associated with the COVID-19 pandemic are already materially impacting parts of both the corporate and sovereign bond markets in areas (respectively) such as the energy sector and frontier emerging markets. A little bit of credit analytical work can go a long way in today's world.

And finally, we have the middle ground option to a backdrop of debt which is inflation. A fixed principal investment such as a bond, even with high interest coupon payments attached, is clearly susceptible to inflation and governments throughout time have attempted to counter debt burdens this way. Certainly a world of extensive central bank balance sheet expansion holds a future inflationary threat... if the velocity of money ever tips back up again.

There are very few panaceas in economic and political life. Extended fiscal deficits are an appropriate pandemic policy response, but if uncontrolled they are likely to overwhelm even a currently becalmed fixed income market. Almost no economies in the world today could cope with materially higher bond yields and hence policy choices should be focused on restoring economy-wide growth and innovation efforts. As the world found out in the generation or three after 1945, it can make an awful lot of sense. ■

KEY TAKEAWAYS:

- Partially due to government fiscal responses to the COVID-19 pandemic challenge, global debt levels are growing.
- Global quantitative easing has contributed to very low bond yields in most major economies.
- The first and best response to public debt is to grow and innovate, as seen in the post World War Two years. This should be a key global government focus over coming years.
- Defaults and inflation are unsurprisingly more troublesome policy options.

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