

INVESTMENT STRATEGY QUARTERLY

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Letter from the Chief Investment Officer

Come On Down! The Ten Themes for 2025

The past two years have been favorable for investors, with the economy and financial markets delivering all the right answers. As we step into 2025, it's a new round, and this one might be more challenging. For inspiration, we're looking to classic game shows. While financial markets are certainly not a game, these shows provide a fitting analogy for the high stakes and strategic thinking required for successful investing. Will the economy and financial markets maintain their momentum? That's the *Million-Dollar Question!* Our answer is yes, but portfolio decisions will need to be more discerning in the year ahead. As we clear the board going into a new year, here are our ten themes for investors and advisors:



1 Optimism Overload: *Family Feud* May Steal the Show

As we move into 2025, optimism abounds—from DC policy to the economy to earnings growth. Consumer confidence, business confidence, and investor confidence have soared, particularly since the election. However, this confidence masks some underlying risks. The sequence, timing, and magnitude of new policies will directly impact the economy.

Some policies, like deregulation and border enforcement, can be implemented immediately. But others, such as taxes and broad tariffs, will require Congressional approval. With a thin margin in the House, potentially as little as a one-vote Republican majority, policy passage could be contentious, much like a round of *Family Feud*. For example, when the Trump tax cuts were passed in 2017, twelve Republicans in the House voted against it. For equity investors, confidence is at a record high, leaving little room for error regarding economic disappointments, a Federal Reserve (Fed) unable to cut rates if inflation picks up, or earnings disappointments. Volatility, historically low, is likely to increase in the upcoming year.



2 Economic Enigma: *Deal or No Deal*

While economic growth is likely to moderate in 2025, we expect it to achieve its fifth consecutive year of positive growth (RJ 2025 GDP forecast: 2.4%). In the game show *Deal or No Deal*, contestants choose from briefcases containing hidden amounts ranging from a penny to \$1 million. We think the recessionary 'bad cases'—such as a Fed-induced over-tightening cycle, a crash in consumer spending, and plummeting business spending—have been taken off the board.

What remains are the 'good cases' that should support economic growth: resilient consumer spending as job growth remains healthy, fiscal spending from programs like the Inflation Reduction Act and CHIPs Act, and continued investment in transformative areas like artificial intelligence. Just as contestants on the show weigh their options and hope for the best outcomes, we anticipate that these positive factors will help sustain economic growth. Assuming the Fed cooperates, the US should remain a standout compared to other developed market economies.

As in the game, though, the outcome is never certain until the last briefcase is opened. Investors must stay vigilant and strategic, ready to adapt to whatever surprises the economic and policy landscape may hold.

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Monetary Policy: *The Newlywed Game*

The Fed has a dual mandate—keeping inflation contained and maintaining full employment. While this is not a new relationship, the post-pandemic world has made it feel like they are newlyweds—especially given the surge in inflation that we are hopefully beyond. Just like a couple on *The Newlywed Game*, the important thing is that this ‘couple’ will need to live in harmony for the Fed to be able to cut interest rates and maintain the current expansion.

The economic growth we foresee should support healthy job creation. Additionally, the disinflationary environment should continue as energy prices fall, retailers promote discounts, the dollar strengthens, and hopefully, shelter prices finally start to retreat. The big wildcard will be the potentially inflationary impact of tariffs, although we believe those risks are overblown.

In the end, while we expect the Fed to cut rates twice in 2025, the focus should be less on the number of cuts and more on the result. Just as in *The Newlywed Game*, where the ultimate goal is a happy and harmonious life together, the outcome we seek is the continuation of this expansion. If this is achieved, risk assets such as the equity market should benefit. By the way, fewer Fed cuts remain supportive for savers as cash yields should average north of 4% throughout the year.



Bond Market *Jeopardy!*: Mastering the Yield Board

In the game show *Jeopardy!*, the answer is a question. In that spirit, we say: “Moderating growth, decelerating inflation, increased volatility, and Fed easing.” If you say, “What could drive interest rates lower?” you are right! And while that ‘question’ would have won on *Jeopardy!*, recent bond market performance has acted to the contrary. Much to the market’s surprise, yields bucked the historic trend and moved higher (rather than lower) after the Fed’s initial rate cut.

Here’s another ‘answer’ for the next round of play: “Upside tariff-driven inflation, upside risk to growth, and potentially increased government spending.” The correct response is: “What could drive interest rates higher?”

In this *Jeopardy!* round, the combination of these answers is why we believe longer-term interest rates will be range-bound for much of the year and end up at a similar level to where they are today

(2025 year-end 10-year Treasury yield target: 4.50%). Since short-term bonds are anchored to Fed actions, continued Fed easing is likely to take short-term rates lower and steepen the yield curve. High-quality corporates and municipals are particularly attractive.



Equities: *Is the Price (or P/E) Right?*

The equity market has experienced a tremendous rally, with the S&P 500 posting consecutive annual returns of more than 20% for the first time since the late 1990s. While earnings growth has contributed, multiple expansion has been a major driver of this performance. As a result, valuations are on the more expensive side.

Think of it like *The Price Is Right*. Investors, much like contestants, need to avoid going over the appropriate price-to-earnings (P/E) multiple, as exceeding it can negatively impact their returns. The game that comes to mind is the ‘Mountain Climber’: the climber ascends steadily, sometimes pausing or moving cautiously, much like stock prices that rise gradually with occasional dips. Just as the climber aims to avoid falling off the edge, investors strive to make informed decisions to prevent significant losses.

While the fundamentals of the market are healthy—a strong economy, positive earnings growth, and robust corporate activity—equity market expectations need to be dialed back in the upcoming year due to high valuations and potential complacency. We expect stock prices to rise more slowly as company earnings grow faster, helping earnings catch up to current prices. We predict the S&P 500 will reach 6,375 by the end of 2025, with a price-to-earnings ratio of 23-24 times and earnings per share of \$270.



Market Capitalization: *Winning the Middle Hollywood Square*

In the game show *Hollywood Squares*, contestants play a version of tic-tac-toe with the help of celebrities who answer questions. A common strategy, used 70%-80% of the time, is to go for the middle square. This is because the middle square offers the most combinations to win, leading to a more balanced strategy in the game.

Similarly, in the equity market, large-cap stocks have dominated over the last two years, while small-cap stocks have recently been in the headlines as beneficiaries of aggressive Fed rate cut expectations. However, mid-cap stocks could be well-positioned to outperform moving forward. Like the middle square in Hollywood

Letter from the Chief Investment Officer (cont.)

Squares, mid-cap stocks offer a balanced approach. They benefit from the strength of the US economy and are somewhat insulated from tariff exposure, with mid caps receiving 76% of their revenues from the US compared to 59% for large caps. Additionally, mid caps are expected to see strong earnings growth of around 13% in 2025 and have attractive valuations—trading at nearly the largest discount to large caps over the last 20 years.

What could further benefit mid caps over small caps is their financing structure. If the Fed is not as aggressive in cutting rates next year, small caps may not reap the benefits of much lower interest rates as investors had expected. Currently, 41% of mid-cap debt is floating rate compared to 53% for small caps. From a fundamental perspective, mid-cap companies tend to be of higher quality, with a higher percentage of companies having positive earnings compared to small caps. Additionally, mid caps have elevated exposure to the Technology and Industrials sectors, which should support their performance.

Just as contestants in *Hollywood Squares* often relied on the center square for a strategic advantage, mid-cap stocks could be the sweet spot in the equity market, balancing growth potential at an attractive valuation.



Sector Selection: *Are You Smarter Than a 5th Grader?*

For our favored sectors, we're going back to the basics—explaining our strategy in a way that even a fifth grader could understand, just like on *Are You Smarter Than a 5th Grader?* For 2025, our approach is simple: follow long-term macro themes and focus on sectors with the best earnings potential. This analysis highlights three key sectors: Technology, Industrials, and Health Care.

Technology is like the star student, excelling due to artificial intelligence, constant innovation, and strong corporate investment, which we believe are still in the early stages. Industrials are the reliable all-rounders, benefiting from continued government spending, the reindustrialization of the US, the AI buildout, and the re-electrification of our power system. Health Care is the underdog with hidden potential, as its attractive valuations don't seem to match the earnings power driven by increasing health-care needs supported by demographic trends.

Just like in the game show, where you need to pick the right answers to win, investors should look for sectors with the best earnings growth. These three sectors are at the top of the class, with earnings comfortably in double-digit territory.



International Equities: *The Weakest Link*

On the show *The Weakest Link*, the sharp-tongued host asks a series of questions, and the contestant with the lowest score each round hears the dreaded phrase, “You are the weakest link. Goodbye.” In the global equity market, the US has consistently been the top performer, much like the strongest link, outperforming other developed markets such as Europe and Japan in eight of the last 10 years. This suggests that the rest of the developed markets have often been the weakest link.

The US is likely to remain the strongest link due to superior economic growth, significantly higher earnings growth, more dynamic corporate leadership, and exposure to our preferred sectors: Technology, Industrials, and Health Care. From a ranking perspective, Japan could provide some competition and ranks just behind the US. Japan is benefiting from an improving economy, a shift away from deflation, and should gain if global growth stabilizes in the coming year. Additionally, with the Bank of Japan raising interest rates, there could be a modest appreciation of the yen, supporting dollar-based performance.



Selectivity: Market Gains No Longer *a Minute to Win It*

In an environment of stretched valuations—which will likely drive increased volatility and more muted returns—the quick, *Minute to Win It* gains we've seen over the past two years will be harder to achieve. Just like the game show, the next stage of the bull market will present progressively tougher challenges for investors to generate returns, making a critical eye on fundamentals essential.

We caution investors against taking on excessive risk across asset classes. Higher beta asset classes without a solid fundamental backdrop will likely face difficulties in the coming year. For example,

with global growth outside the US expected to struggle, commodities (particularly oil) may encounter headwinds as demand growth remains subdued. Within the equity market, companies without positive earnings will likely come under pressure.

Additionally, we anticipate increased dispersion among winners and losers within regions, sectors, and industries. In a shifting policy landscape, 2025 will likely be a year where active management, especially in commodities, emerging markets, and small caps, proves its worth. Investors will need to stay focused and adaptable to navigate the complexities of the market.



Asset Allocation: Playing the *Wheel of Fortune*

Amidst the uncertainty of the coming year, it's important to remember the goal of investing: to build wealth. The aspiration of becoming a millionaire, as in *Who Wants to Be a Millionaire?* might seem modest now. When the show started in 1999, \$1 million would be worth about \$2 million today adjusted for inflation, and around ~\$9 million adjusted for equity performance.

America's wealth has grown to record highs. But don't spin the Wheel of Fortune on your own! When you're ready to buy a vowel (i.e., make additional investments), consult with your financial advisor first. Your advisor is like the 'phone-a-friend' or 'lifeline' you can rely on to answer your questions and provide reassurance when faced with pressure-panicked headlines.

We are prepared for the challenges ahead, keeping in mind the expression that applies to all game shows and certainly to financial markets as well: "You've got to be in it to win it." Stay focused and committed!

So come on down!

Lawrence V. Adam, III, CFA, CIMA®, CFP®
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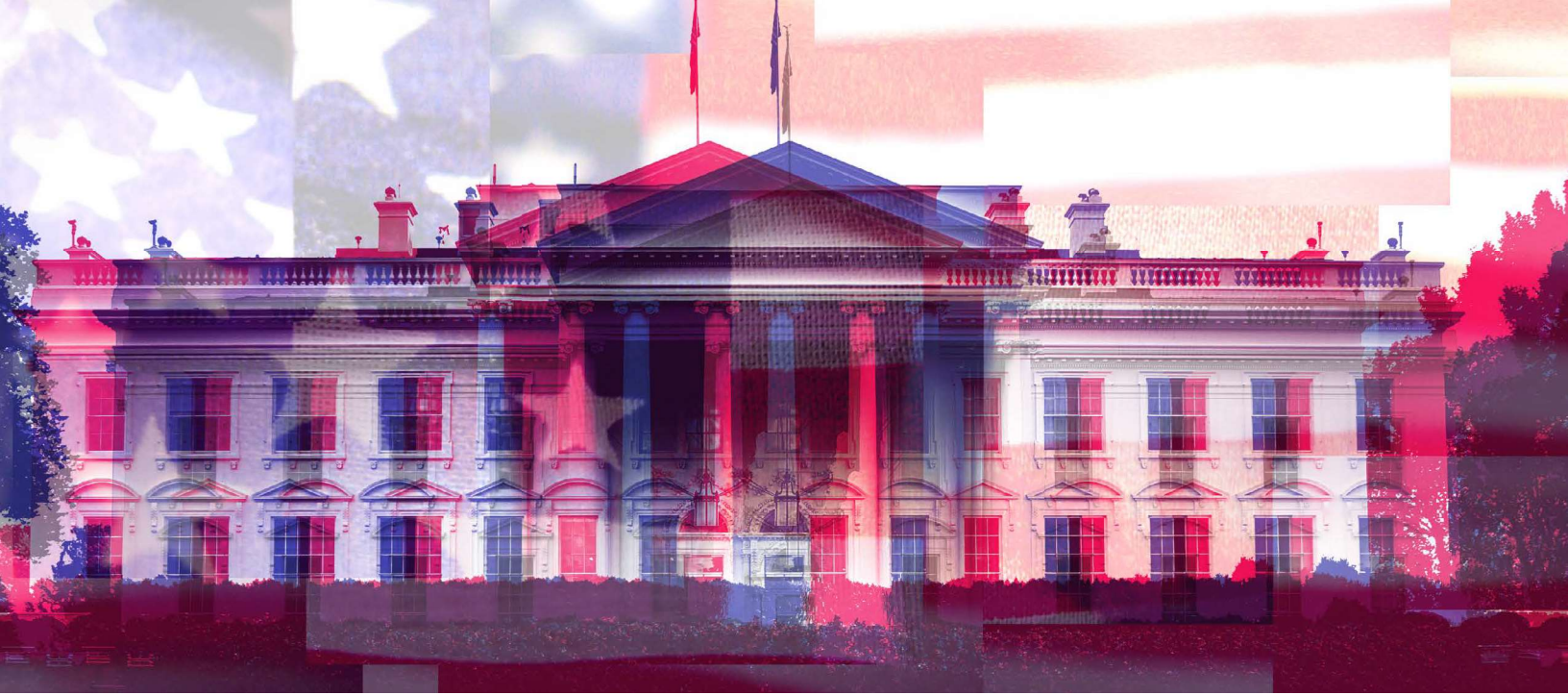
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Trump 2.0: What's New and What's Déjà Vu?

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

The election of Donald Trump to a second term and the GOP sweep of Congress is a repeat of the 2016 election, but we see a considerable debate about the agenda for his second term. Echoing his first term, tax change, tariffs, and immigration all remain at the top of his agenda. In the ‘what’s new’ camp we highlight a much smaller Republican House majority (in the single digits, compared to the 23-seat majority of 2017), but more Congressional allies and a more robust transition team. A key dividing line for the 2025 policy agenda will be agenda items that can be achieved through executive authorities (including tariffs and immigration), and those requiring Congressional authorization (such as taxes and the debt limit). It will likely be full speed ahead for many of those executive-driven actions given Trump is seeking to avoid the multi-year negotiations that delayed his first term agenda.

The small House majority will introduce new hurdles to the passage of key fiscal legislation, including raising the debt limit, extending the 2017 Tax Cuts and Jobs Act ahead of its expiration in December, and any desired changes or repeals to the 2022 Inflation Reduction Act. A guiding principle for watching Trump 2.0 will be to ‘expect the unexpected’ and we expect to see frequent diversions from the traditional DC playbook. With that uncertainty as a caveat, we attempt to provide a playbook for how some of the top market-relevant DC fights could play out in 2025.

A guiding principle for watching Trump 2.0 will be to ‘expect the unexpected.’

“ We view his nominations to key posts (including Treasury, Commerce, and the US Trade Representative) as early indicators of his seriousness for aggressive trade and tariff actions. ”



TARIFFS

Tariffs have formed the centerpiece of Trump’s fiscal and foreign policy agendas, and our base case is that tariffs (including those targeted at specific countries, as well as a global tariff), are coming—but the specifics remain up in the air. As an example, Trump has already vowed to

impose sweeping Day 1 tariffs on China, Mexico, and Canada in response to fentanyl and immigration concerns. The pre-inauguration announcement of the tariffs underscores a key dynamic in Trump’s tariff strategy: his desire to negotiate and make deals. The timing should be viewed as an initial attempt to bring potentially impacted countries to the negotiating table early on. Trump will highlight in his negotiations that each country can avoid these tariffs by addressing his concerns, but his wish to negotiate does not mean he will not follow through on his tariff threats if a desired outcome is not secured. Trump has a range of authorities at his disposal to implement his suite of tariff proposals which also includes the authority to impose a 10-20% global tariff. Several of those authorities would allow him to implement new tariffs almost immediately, and even for tariffs with longer procedural requirements, we would expect those to move relatively quickly.

Additionally, we view his nominations to key posts (including Treasury, Commerce, and the US Trade Representative) as early indicators of his seriousness regarding aggressive trade and tariff actions. Congress is also likely to support these actions and could provide new authority that would allow the president to address trade deficits and tariff barriers imposed by other countries against the US. These new powers could usher in trade deals that would be viewed as significant benefits to US companies and US exports. Ultimately, the timing and scope of these actions will dictate the economic and market impact.



PERSONNEL IS POLICY

Key to the policy specifics and implementation of priority agenda items will be the personnel appointed to manage those issues. While Trump announced his cabinet picks and other key appointees throughout November and December, the fate of many of his selections will lie with

the Senate confirmation process. The Republican Senate majority and a push for deference to the president will mean that many will be confirmed, but some of the more controversial picks will face an uphill battle. Trump has indicated his willingness to use recess appointments if the Senate does not approve his nominees. Legal hurdles implemented by the Supreme Court in 2014, following the use of this power by President Obama, limits this authority. The 2014 ruling adds to the uncertainty of the outcome.



DEBT LIMIT

Alongside personnel confirmations, the return of the debt limit will be a top priority in the early days of the new 119th Congress. While we expect the debt ceiling to eventually be raised, the narrow House GOP majority, the number of Republican members of Congress who

have never and will never vote to raise the debt limit and the political drama previewed in the December 2024 government funding debate will likely introduce volatility to the process. The debt limit is subject to a 60-vote threshold in the Senate, requiring Democratic support for its passage. Using the last debt limit debate as a guide, we would expect the X-date (when the US government can no longer fulfil its debt obligations through the use of extraordinary measures) to fall roughly mid-year, and the debt limit debate will accordingly become a priority in the first half of 2025. On politically tough votes, additional measures are frequently added to provide incentive for members to vote in support; therefore, it is likely that measures to speed up infrastructure and energy-related projects are added to the increase in the debt limit. This would be viewed as adding to the economic growth of the US and positive for industrial projects.



DOGE & THE BUDGET

Trump's announcement of the 'Department of Government Efficiency' (DOGE), to be led by Elon Musk and Vivek Ramaswamy, has pushed the US budget and its process into the spotlight. We expect DOGE to have the most success in its push for deregulation, aided by a series of Supreme

Court rulings that will make it easier to challenge existing regulations. Their effort to reduce government spending will be a more difficult challenge. A key challenge will be getting Congress to support their budget cut recommendations. The slim House Republican majority and the 60-vote threshold in the Senate are key hurdles here. A wildcard in this effort will be a court challenge to limits on the president's authority to withhold funds appropriated by Congress. We expect the Trump administration to challenge a 1974 law that restricts this authority. The outcome of that court case could determine the extent of the budget impact of DOGE. Separately, there are areas where increased near-term government spending may be suggested to increase longer-term government efficiency. Many government technologies are outdated and with the tech backgrounds of Musk and Ramaswamy, we could see an effort for upgrades that have better cybersecurity and position the US government for efficiency.

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TAX CUTS

The individual portions of the 2017 Tax Cuts and Jobs Act (TCJA) are set to expire on December 31, 2025. The cost of a ten-year extension is estimated at \$4.6 trillion, and President Trump has promised additional changes to the tax code as part of this extension. Most of the corporate tax

changes, including the 21% corporate tax rate, were made permanent in 2017, while several important business provisions that incentivize investment in new equipment have expired and are part of the extension conversation. We expect Congress to use the budget reconciliation process to pass this tax law, as it only requires a simple majority in the House and Senate (no 60-vote Senate filibuster) for passage. As such, we expect the bill to pass on a party-line vote. The lower vote threshold does not guarantee smooth sailing, as the House majority is razor thin.

The slim House Republican majority and the 60-vote threshold in the Senate (which requires Democratic support) are key hurdles.

Our base case for the tax bill is an extension of the expiring provisions, but the extension may be shortened to four or five years (versus the ten years allowed under congressional rules) to reduce the cost of the extension. A four or five-year extension would cost closer to \$2 trillion. The tax bill is likely to include provisions such as the no tax on tips, overtime, and Social Security promoted by President-elect Trump during the campaign. However, those provisions are likely limited to lower-income households that are already excluded from paying federal income taxes.

The debate over the state and local tax (SALT) deduction cap will likely be a major battleground (and key example of the precariousness of such a slim House majority), especially for House Republicans in jurisdictions with high state and local taxes, such as New York, New Jersey, and California. There have been proposals to increase the current SALT limit from \$10,000 to \$20,000, while limiting the extra deductions for households with income less than \$500,000. The expiration of the current estate tax limit is likely to be extended as part of the larger package, but we will be watching developments closely.

Offsetting the cost of these tax changes could have significant market and sector impacts. New tariff authority, the potential repeal, repeal of the Inflation Reduction Act (IRA), entitlement reform, cuts suggested by DOGE, and many other provisions are all on the list of potential offsets. ■

KEY TAKEAWAYS:

- We view the key market-relevant policies of the Trump administration as: tariffs; the debt limit; appointing key personnel; budget reduction; and tax cuts.
- Trump's appointments seem to indicate his seriousness about aggressive policies on tariffs and trade policy. Tariffs may also be used as a negotiating tool.
- The timing, magnitude, and tempo of these policies is still uncertain. We will be monitoring market reaction closely.



Bytes and Barrels: Energy Market Shifts Focus from Geopolitics to the Electric Grid

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

After a year of major wars in Europe and the Middle East, how is it that oil prices ended 2024 lower than where they started? As it turns out, geopolitics is not everything. Russia's war in Ukraine has faded into a depressing, seemingly endless backdrop. Israel's war with Hamas, Hezbollah, and—on two occasions—direct confrontation with Iran has been more headline-grabbing but without any direct effect on oil supply. The oil market has become rather numb to these headlines, and day-to-day volatility in oil prices is being driven by rather old-fashioned supply-side and demand-side factors. China's macroeconomic troubles, compounded by its fastest adoption of electric vehicles among the G20 major economies, helps explain the less than bullish sentiment vis-à-vis oil demand. Meanwhile, the long period of OPEC+ production discipline may be starting to unwind, with the group planning to boost production starting in April 2025. Balancing all of these considerations, we anticipate that oil prices will

remain generally range-bound in 2025. This implies West Texas Intermediate (WTI) and Brent crude averaging in the \$65 to \$85/Bbl range.

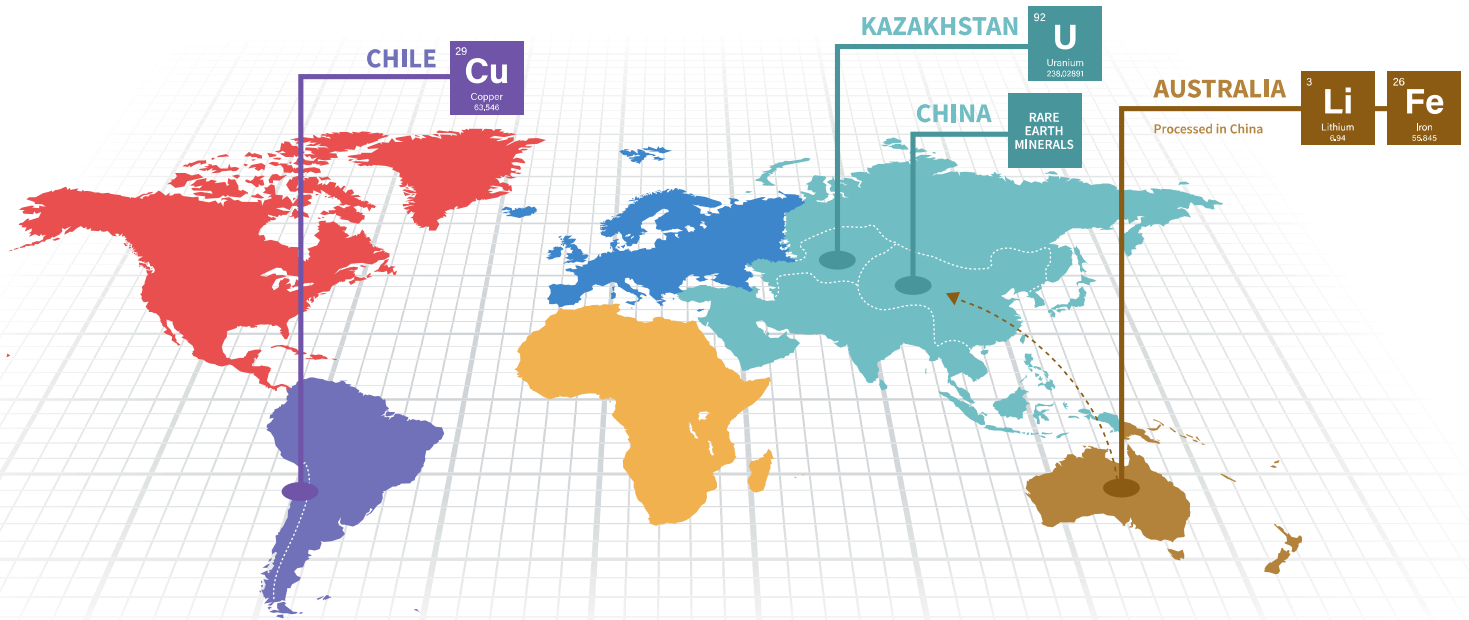
For the first time in two decades, US electricity demand is embarking on a period of sustained growth, mostly due to the highly energy-intensive data centers for the AI buildout.

AI AND POWER

Insofar as one story in the energy sector truly stood out over the past year, it is entirely separate from the oil market. We are referring to the interplay of artificial intelligence (AI) and the electric power industry. For the first time in two decades, US electricity demand is embarking on a period of sustained growth, mostly

Strategic Materials Distribution

Materials like copper, lithium, and iron play key roles in supporting the electric power boom. Much of the processing occurs in China.



Source: US Geological Survey

due to the highly energy-intensive data centers for the AI buildout. After increasing by an average of only 0.4% per year between 2000 and 2023, we forecast that US electricity demand will be growing 2% to 3% per year through 2030. In fact, there is no need to ask whether this growth is real—2024 was up more than 3%. Accommodating this growth will be a textbook case study of an all-of-the-above story: natural gas, wind, solar, nuclear, and let's also keep in mind the importance of modernizing the electric grid. The US is leading the way in AI—Washington, DC has more data centers than any metro area in the world—but AI will also contribute to electricity demand in Europe and various emerging markets. In fact, the world's top 20 data center markets can be found across 11 countries on four continents, with Beijing ranking #2 behind Washington. As this growth curve continues, there will be plenty of opportunities and challenges along the way. We always need to be mindful of delays: development of power plants and the associated grid infrastructure is a marathon rather than a sprint. This is especially true of anything nuclear-related, which for obvious reasons is closely scrutinized by regulators and takes a very long time to build.

STRATEGIC MATERIALS: WHERE OH WHERE?

Among the aspects of the electric power boom that is not always appreciated is the need for a wide range of strategic materials. Copper, for example, is a key input for electric cabling. Grid-scale power storage systems that incorporate lithium-ion batteries (the same type of batteries used in electric vehicles) require lithium, nickel, manganese, and cobalt. And, needless to say, practically all industrial construction uses steel in massive quantities. Unlike precious metals, the various industrial metals are not scarce in a geological sense, but the supply tends to be geographically concentrated. Nearly one-fourth of the world's copper comes from Chile. Lithium comes mostly from Australia, with the processing handled almost entirely in China. Likewise, Australia is the world's largest supplier of iron ore, which is shipped to China where more than half of the world's steel is produced. Kazakhstan produces nearly half of the world's uranium—which, of course, is vital for nuclear power plants—though there is more concern about the 5% that comes from Russia. As it relates to mining, China is most dominant in rare earths, providing two-thirds of global supply.

“ What we like to call ‘electrification of everything’ is a megatrend that encompasses data centers, electric vehicles, and more. ”

THE REGULATORY VIEW

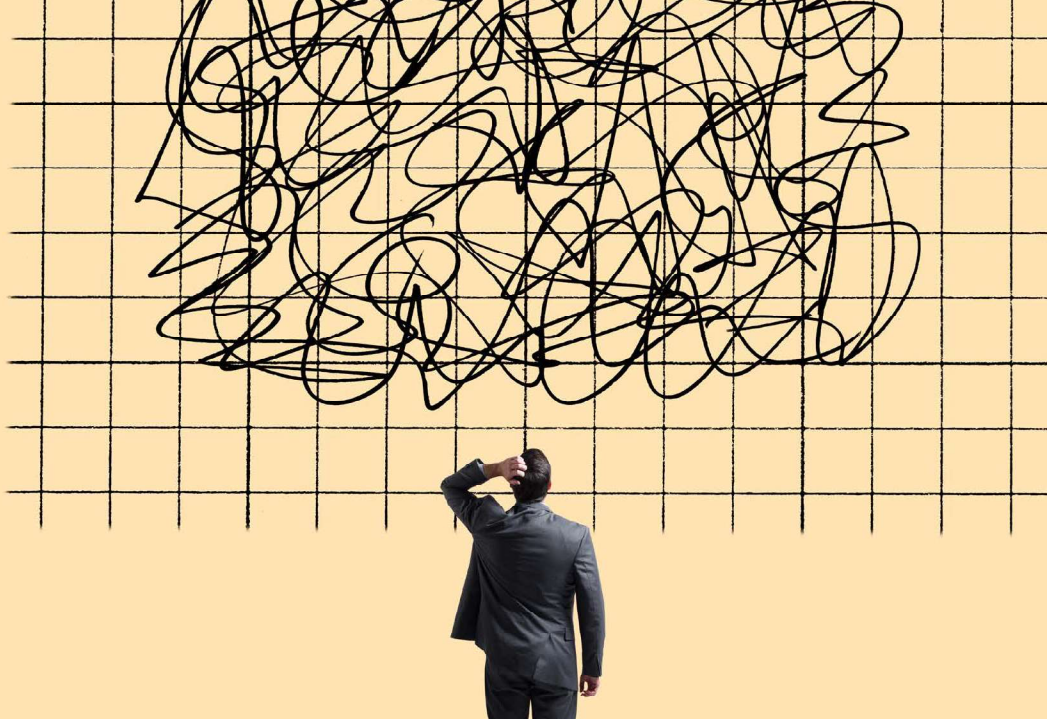
The past year was uniquely full of elections in major economies around the world. For our US readers, it is hardly a secret that the incoming Trump 2.0 administration will be much less climate-focused than its predecessor. Environmental regulation will become weaker at the federal level, but there is a more complex landscape at the state level, which is where utilities are generally regulated. Turning to what’s been happening internationally, in France there is parliamentary gridlock, which means that the status quo of high reliance on nuclear power is continuing. The Labour Party in the UK is building on the environmental policies of the previous Conservative government—notably, the UK’s last coal-fired power plant was shut down in September 2024—and has started to provide more funding for offshore wind. South Africa’s coalition government is talking about diversifying the country’s electricity mix away from coal but needs to manage the political pressure from the mining industry. In 2025, there will be important elections in Canada and Germany, and we will be watching for any potential changes in energy and climate policy. On both sides of the Atlantic, one of the areas where parties on the left and right tend to find agreement these days is economic protectionism, which includes hefty import tariffs on Chinese solar panels and electric vehicles.

THE BOTTOM LINE

The key message here for investors is that it is not enough to consider the price dynamics of any given commodity—we also need to think about how the volumes are growing. We anticipate that global electricity demand will grow 2% to 3% per year through 2030, whereas oil demand is set to grow less than 1% per year. Regardless of whether oil prices are green or red on your screen on a day-to-day basis, the underlying market for electric power is expanding more rapidly. What we like to call ‘electrification of everything’ is a megatrend that encompasses data centers, electric vehicles, and more. Likewise, mine output of the metal with which investors are most familiar—gold—is essentially static, whereas there is robust growth in key industrial metals such as copper and lithium. As useful as gold can be from an inflation hedging standpoint, the underlying volumes have plateaued, and investors who want growth—without needing to make a bet on commodity prices—may want to consider other opportunities in the metals and mining sector. ■

KEY TAKEAWAYS

- Oil price volatility is being driven by old-fashioned supply-side and demand-side factors.
- We anticipate that oil prices will remain generally range-bound in 2025. This implies West Texas Intermediate (WTI) and Brent crude averaging in the \$65 to \$85/Bbl range.
- US electricity demand will grow 2-3% per year through 2030 largely on the back of AI data centers.
- There will be a growing need for strategic materials, most of which are found outside the US.



Uncertainty is Dead, Long Live Uncertainty

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

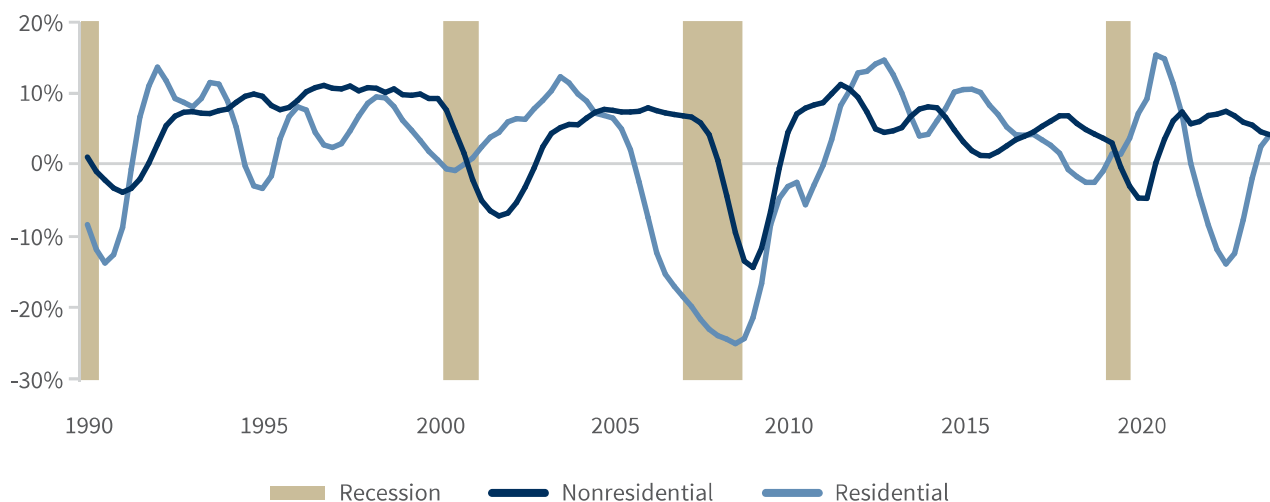
The results of the presidential election as well as those of the US Congress, with a Republican sweep, ended months of uncertainty regarding the next few years. Since then, markets have been salivating at the prospects of a more benevolent regulatory environment vis-à-vis the Democratic alternative. At the same time, markets seem to have become very positive on the prospects of a unified government that should, potentially, take some of the typical uncertainties off the table, i.e., a non-contested extension of the debt ceiling, etc. Having more certainty is great for markets. Still, the Republican sweep opens other uncertainty avenues that could affect the prospects for economic growth, inflation, and interest rates going forward.

ECONOMIC GROWTH

As has been the case for the last several years, economic growth continues to be on a strong footing, helped lately by very strong

tailwinds created by the fiscal expansion provided by the CHIPS, IRA, and Infrastructure Acts as well as by a weakening but still relatively strong employment environment. Furthermore, the last several years have shown that, while important, the manufacturing sector's weakness should not prevent the US economy from continuing to show economic strength. Perhaps the only caveat to our previous argument is that both the CHIPS and IRA legislation have kept nonresidential investment strong during a period when residential investment as well as current manufacturing production were very weak. Thus, investment in the nonresidential sector has remained positive even in the face of very high interest rates. As these new manufacturing plants continue to be built, the prospects for the US manufacturing sector will tend to improve. At the same time, the fiscal acts have also kept the US construction sector as well as construction employment in expansion, even as the residential investment sector plunged into recession. As long as the new administration's policies tend to keep this economic environment more or less unchanged, the US economy can continue to grow over the next several years. If that is not the case, then once we have the new policies implemented, we will assess the potential effects on economic growth.

Residential vs. Nonresidential Investment (Four-Quarter Moving Average)



Source: FactSet, data as of 12/31/2024

Trusting energy prices to continue to behave in support of the Fed’s monetary policy objectives is not a sustainable (or even recommended) strategy.

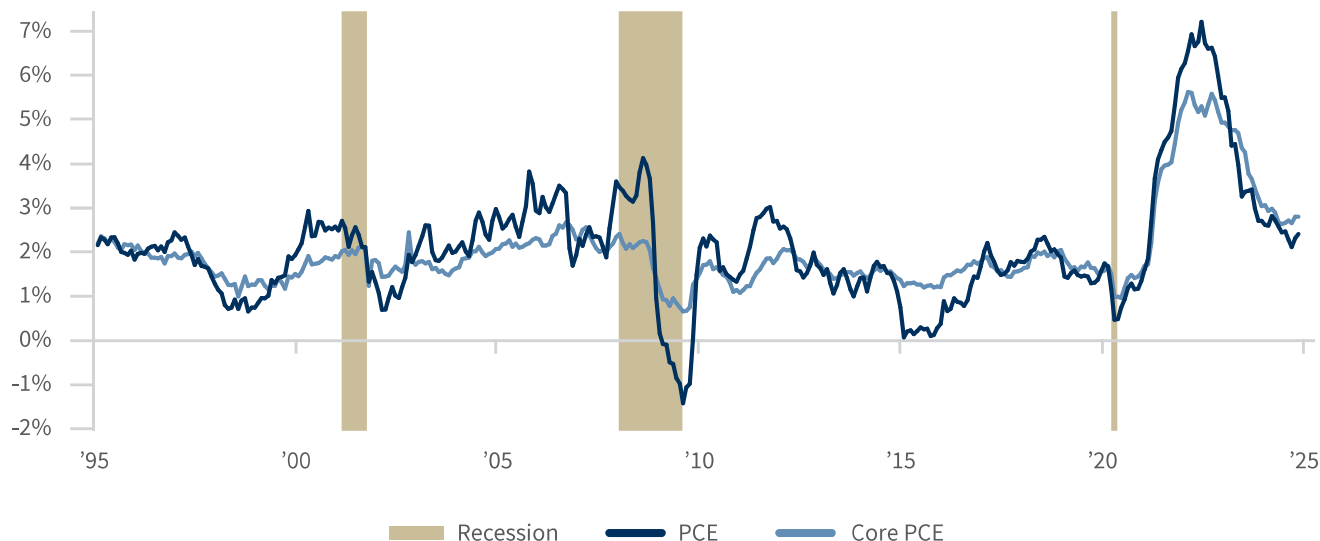
INFLATION

Strong growth during the last several years has not prevented inflation from decelerating after what happened in 2021 and 2022. The normalization of supply chains, the drawdown of excess savings over time together with the ‘revenge spending’ triggered by the end of the pandemic, as well as the Federal Reserve’s (Fed) high interest rate policies have allowed inflation, finally, to approach the Fed’s target of 2.0%. However, the path to the 2.0% target rate has been slower than Fed officials would have liked as shelter costs have continued to remain uncharacteristically strong during this period compared to the past. At the same time, Fed officials have been very lucky as energy prices have continued to support lower inflation. However, trusting energy prices to continue to behave in support of the Fed’s monetary policy objectives is not a sustainable (or even recommended) strategy.

Furthermore, although the headline PCE price index is the Fed’s target inflation measure, Fed officials would like to see some further weakening of core inflation. That is, it prefers to see the core PCE, the personal consumption expenditures price index excluding food and energy prices, sustainably closer or even below the 2.0% target so it has some wiggle room to deal with the headline rate of inflation moving up or down temporarily without affecting the core PCE rate of inflation. This is the part of the inflation fight the Fed has not been able to win yet. This stability in the core PCE rate of inflation is a much longer-term objective, but one without which the Fed cannot be successful.

Today, the Fed has to deal with the potentially inflationary consequences of the incoming administration’s policies, especially regarding tariffs as well as deportation of illegal aliens. Although there are still unknown details such as the depth, extent, and application of such policies, an analysis of the economic consequences points to potentially higher inflation going forward. As we have said in the past, it is not that we believe we will have higher inflation going forward—however, if there is the potential for inflation to move higher in the future, this will trigger a change in Fed monetary policy, which could include interest rates staying high for longer or even pushing the Fed to increase rates if the inflationary consequences of these new policies merit such a move.

PCE and Core PCE Price Indices (YoY Change)



Source: FactSet, as of 12/31/2024

INTEREST RATES

We have left interest rates for last because economic growth as well as inflation will determine the path of interest rates. This has been confirmed by markets, which are now expecting high interest rates to stay with us for a longer period of time. And we agree with markets at this junction. For now, elevated interest rates have not been a constraint on economic growth. High interest rates have not been binding for real nonresidential investment while they have been binding for real residential investment. However, as the effects of the fiscal expansion created by the CHIPS and IRA, and to a lesser extent, the Infrastructure Act, continue to fade away, interest rates are going to become a constraint on economic growth.

But perhaps the biggest risks for the US economy are higher interest rates from potentially higher inflation due to tariffs and the proposed deportation of millions of illegal migrants. While the impact on inflation from the curtailment of illegal immigration is going to take some time to feed into wages across the different industries affected, i.e., construction, agriculture, hospitality, etc. (see infographic on next page), and then into inflation, the effects of the imposition of tariffs on imports from the rest of the world is going to have an almost immediate impact.

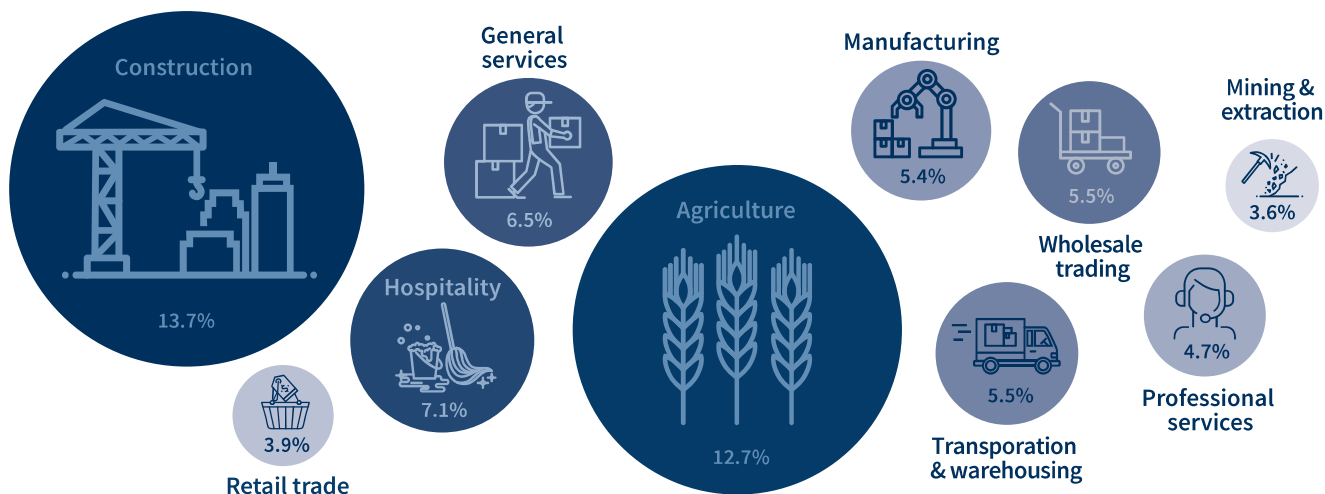
The biggest risks for the US economy are higher interest rates from potentially higher inflation due to tariffs and the proposed deportation of millions of illegal migrants.

We could even start seeing some of the impacts from tariffs during the fourth quarter of this year and the first quarter of next year, not through higher inflation but through higher imports as firms try to front load any increase in future tariffs by replenishing inventories ahead of the increase in price. These added imports could weaken economic growth somewhat in Q4 2024 and Q1 2025 compared to a no-tariff environment.

Once again, we want to be mindful of the few details available regarding the implementation, breadth, and scope of the potential tariffs—our analysis is just an interpretation of publicly available information. You can also read our fourth quarter 2024 Investment Strategy Quarterly article in which we covered this topic in some more detail.

Share of Undocumented Workers by Industry

The impact on inflation from the curtailment of illegal immigration is going to take some time to feed into wages across the different industries affected.



Source: American Immigration Council, as of 2022

But the fact of the matter is that the imposition of tariffs on imports will increase the price of those goods that are covered by the tariffs as well as generate an increase in the prices of domestically produced goods that compete with the imported goods that are covered by tariffs. At the same time, tariffs will increase the price of inputs used in production and these increases in the cost of production will find their way into the final price to consumers. Higher inflation will push the Fed to keep interest rates higher for longer and/or increase interest rates further.

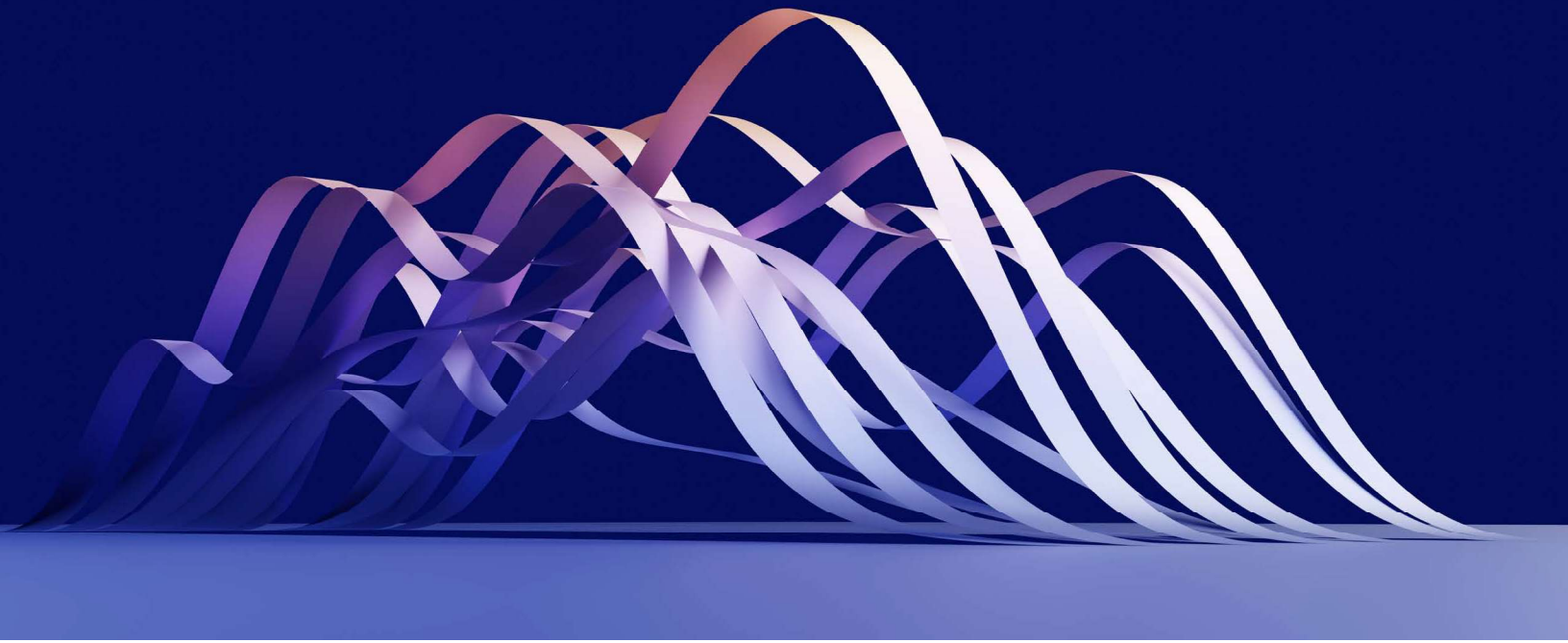
All this means that today's interest rate path is higher than it was before the results of the presidential election. Fundamentally, this is because the prospects for economic growth today have improved marginally but primarily because the prospects for higher inflation have changed materially, which will keep the Fed in a defensive position. At the same time, this new interest rate path may increase the risks of a recession down the road, especially if the effects of the new policies increase the rate of inflation more than markets expect.

Once again, and going back to the title of this article, while the November 5 presidential and congressional elections cleared the path of one set of uncertainties, it also added another completely

different set of uncertainties that markets, investors, and economists, will have to deal with going forward to figure out the path for economic growth, inflation, and interest rates during the next several years. ■

KEY TAKEAWAYS

- While the results of the election in November resolved some uncertainties, it opened the door to others which could affect the prospects for economic growth, inflation, and interest rates going forward.
- Economic growth continues to be on a strong footing, helped by the very strong tailwinds created by the fiscal expansion provided by the CHIPS, IRA, and Infrastructure Acts as well as by a weakening but still relatively strong employment environment.
- Inflation has, finally, approached the Fed's target of 2.0%.
- Economic growth as well as inflation will determine the path of interest rates going forward.



Fixed Income: The Long and Short of It

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

Throughout 2024, the path to economic normalization continued. Federal Reserve (Fed) policymakers made substantial progress bringing inflation closer to target and labor markets moved better into balance—all without triggering a recession. This allowed the Fed to kick off its easing cycle after the second longest pause (i.e., the time between the final rate hike and the first rate cut) on record. While rate cuts have traditionally been supportive for the bond market, this cycle continues to beat to its own drum. In a departure from the historical pattern typically seen after Fed rate cuts, Treasury yields have marched significantly higher since the Fed's initial rate cut. As we step into 2025, the outlook for fixed income remains favorable (particularly for short to intermediate bonds) but there are plenty of risks on the horizon that could knock the bond market off course.

A SHALLOWER EASING CYCLE

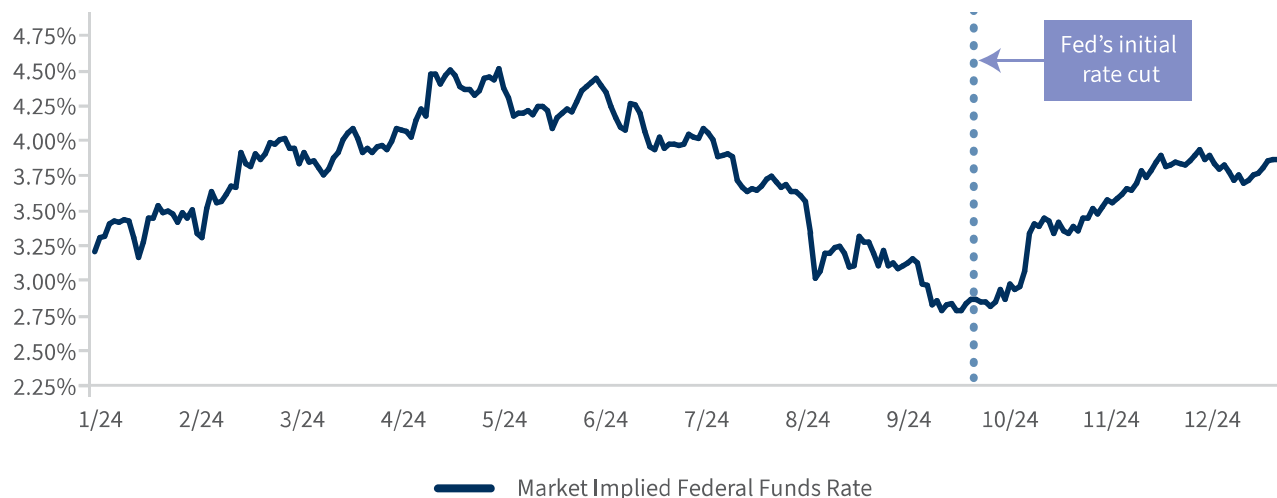
The Fed's 100 bps of 'insurance' cuts in 2024 have prolonged the economic expansion, which has been ongoing for 19 consecutive quarters. While downside risks to the job market were mounting last summer, the Fed's jumbo-sized 50 bps rate cut last September—followed by two additional 25 bps rate cuts in November and December—helped the economy dodge a downturn. This, combined with the burst in optimism following the presidential election outcome has bolstered the case for a soft landing. As a result, the US economy is entering 2025 with considerable momentum. In fact, our economists expect the economy to grow at a modestly above trend pace of 2.4% next year.

The economy is entering 2025 with considerable momentum and our economists expect it to grow at a modestly above-trend pace of 2.4% next year.

The better than expected economic backdrop has altered the outlook for the Fed's expected rate path. Policymakers can afford to be patient with future rate cuts as there is no longer a pressing need to

Expectations for Terminal Rate

Markets originally expected up to four cuts in 2025, now expecting only two.



Source: FactSet, data as of 12/26/2024

stimulate growth now that the downside risks to the economy have dissipated. While Fed officials still see policy rates as restrictive, the outlook for 2025 has become less certain—with market expectations now pricing in slower pace of easing. In fact, the terminal rate (i.e., rate that neither stimulates nor restricts growth) has climbed nearly 100 bps since the Fed’s initial rate cut in September—with 3.75% - 4.00% now expected by year end 2025.

This has implications for the bond market. With the market now discounting that the Fed’s terminal rate plateaus at a higher level than Fed officials’ current 3.0% estimate, it means we are unlikely to see a meaningful decline in bond yields from current levels. But with a soft landing coming into focus in 2025 and significant policy uncertainty on the horizon, yields are likely to remain range-bound for much of the year. However, gentle upward pressure on longer maturities is likely as yields factor in a modest risk premium to reflect the growing list of uncertainties on the horizon.

RISKS ARE TILTED MODESTLY TO THE UPSIDE

Shorter-maturity yields are often considered a proxy for the near-term rate outlook. With the fed funds rate likely to settle in the vicinity of 4.0% next year, a 2-year Treasury yield of ~4.3% seems attractively priced based on current Fed rate cut expectations.

However, longer-maturity bonds could see a gentle upward shift. Why? That’s because longer-term bond yields are primarily driven by expectations for growth and inflation, and to a lesser extent, should incorporate some additional compensation to reflect the deteriorating fiscal outlook. With the economy still growing at an above trend rate, the disinflationary trend stalling, and the nation’s debt and deficits at unsustainably high levels (and still rising), we are growing more cautious on longer maturities. That is why we have raised our 10-year Treasury yield target to 4.50% for 2025. However, we are more inclined to play the ranges this year, adding duration when yields overshoot and cutting duration as yields move back toward 4.0%. Absent another growth scare (not our base case), we see limited room for a meaningful decline in Treasury yields from current levels. Given the uncertainties that lie ahead, here are three factors that could put modest upward pressure on bond yields in 2025:

We are growing more cautious on longer-term maturities. That is why we have raised our 10-year Treasury yield target to 4.50% for 2025.

Inflation Plateaus At A Higher Level

Inflation has cooled notably from its 2022 peak—falling from a high of ~9% to around 2.7%. However, the disinflationary progress has stalled, with core inflation (currently at 3.3%) settling above the Fed's 2.0% target. This comes at a time when the new administration's policy proposals (i.e., broad tariffs, tax cuts, immigration crackdown) could stoke inflationary pressures again. While there is still much uncertainty as to the timing, magnitude and sequencing of these policy initiatives, the bond market could remain on edge until there is more clarity on what ultimately gets implemented.

Deteriorating Debt Dynamics

With the national debt crossing over \$36 trillion in November, and the deficit at its widest level (~6% of GDP) going back to the 1930s excluding the World War II, Great Financial Crisis and COVID periods—debt dynamics will remain front and center in 2025. For example, the market is starting to price in the impact of extending the expiring 2017 tax cuts and other campaign promises (i.e., no tax on tips, overtime pay or Social Security benefits). These measures, if enacted, could worsen the deficit and lead to greater Treasury issuance—which has the potential to drive yields higher, particularly for longer-dated maturities. While the US enjoys an enormous advantage as the world's reserve currency, it cannot continue to increase its debt and deficit indefinitely. Eventually investors will demand extra compensation to hold US debt and there is not much additional premium factored into bond yields at the moment.

Fed's Neutral Rate Shifts Higher

The neutral rate of interest is an important concept for policymakers that guides their decision-making process—serving as a guidepost for an interest rate that neither stimulates nor restricts economic growth. Since the Great Financial Crisis, the Fed's longer-run estimate has steadily fallen from above 4% to a low of 2.5%. The challenge for policymakers is to determine what this level should be going forward—which has been complicated in recent years as the economy is still adjusting to all the supply/demand shocks following the pandemic. However, given the economy's resilience, the Fed's neutral rate estimate is steadily moving higher (the median dot was most recently at 3.0%). Further upward shifts in the Fed's neutral rate estimate could push bond yields higher.

OPPORTUNITIES IN 2025

With the economy on track to achieve a soft landing and yields likely to stabilize around current levels, here are a few places where we see opportunities in 2025:

Favor Short to Intermediate Maturities

With the latest back up in Treasury yields, short to intermediate bonds are now comfortably above 4.0%. While interest rates are below their recent peak of ~5% in April 2024, yields remain elevated and attractive on a historic basis. Investors have another opportunity to lock in attractively priced yields without enduring the price swings that come from longer duration assets, which are more sensitive to changes in interest rates.

Embrace High Quality Corporates for Yield, Not Spread

While corporate bond spreads are hovering near multi-year lows and could be vulnerable to profit taking or a short-term setback, we think spreads are more likely to remain range-bound in 2025—similar to how they reacted during the last soft landing in 1995. Although we do not foresee much opportunity for spread compression in 2025, with economic growth likely to remain resilient and credit fundamentals (i.e., rising earnings, strong balance sheets, robust cash positions) still healthy, investors can still capture historically attractive yields above 5+% while earning modest compensation for taking on additional credit risk.

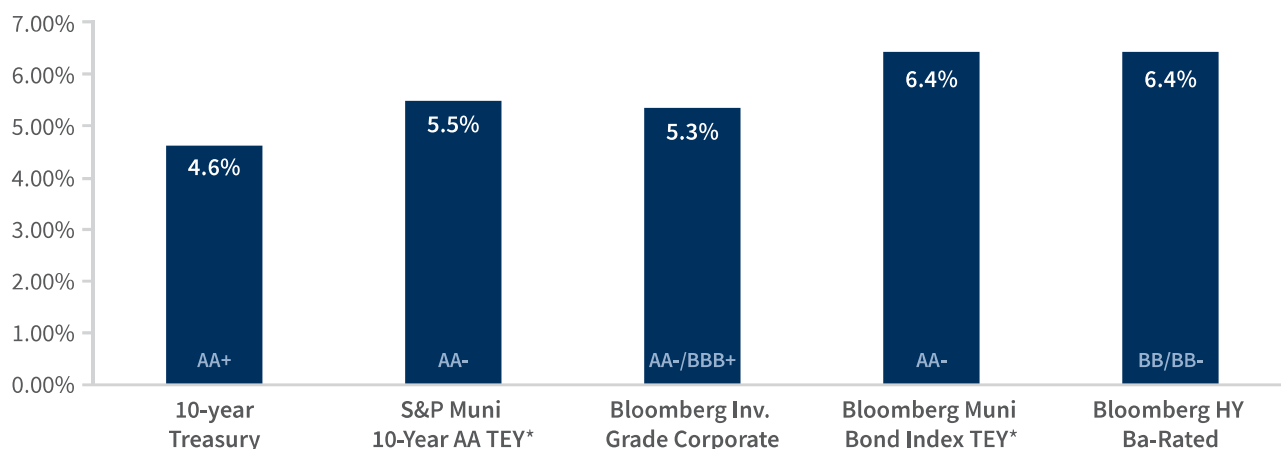
Munis Offer Favorable Tax Equivalent Yields

We are constructive on municipal bonds in 2025 as tax-equivalent yields offer a compelling opportunity—particularly for investors in the highest tax brackets. For example, the tax-equivalent yield on the Bloomberg Municipal Bond Index is ~6.4%—that compares to a 4.6% yield on the 10-year Treasury. Not only are municipals attractively priced relative to Treasuries, munis also offer a significant yield pickup relative to the Bloomberg Aggregate Bond Index and investment grade corporate bonds. With the municipal yield curve significantly steeper than the Treasury yield curve, there is an opportunity to lock in attractive yields on longer-dated paper.

Absent another growth scare, we see limited room for a meaningful decline in longer maturity Treasury yields from current levels.

Municipal Tax-Equivalent Yields Remain Attractive

Munis offer a significant yield opportunity relative to the Bloomberg Aggregate Bond Index and investment grade corporate bonds.



*Taxable-Equivalent Yield calculation assumes a top tax bracket of 40.8%.
Source: FactSet, data as of 12/31/2024

BOTTOM LINE

While we do not anticipate a meaningful decline in bond yields in the year ahead, the outlook for bonds in 2025 remains favorable. With yields remaining historically elevated (at least relative to the last fifteen years), investors still have an opportunity to capture reasonable income from the fixed income side of their portfolios. Although with plenty of potential risks on the horizon, investors need to remain vigilant. We remain cautious on taking on too much duration risk (a measure of interest rate exposure) in the current environment and believe the risk/reward is more attractive for short to intermediate maturities, particularly in light of our view that the Fed’s easing cycle should continue in 2025. We also favor high-quality corporate and municipals bonds—which can benefit from solid fundamentals and yields that remain at historically attractive levels. ■

KEY TAKEAWAYS:

- The Fed’s ongoing easing cycle should benefit short to intermediate maturities.
- We remain cautious on longer duration assets given deteriorating debt dynamics.
- Take advantage of the attractive tax-equivalent yields for municipal bonds.



Resetting Equity Expectations

Matt Barry, CFA, *Senior Investment Strategist*, Investment Strategy
Mike Payne, *Investment Strategy Analyst*, Investment Strategy

2024 was a remarkable year for the equity market. The S&P 500 has gained 27% as of this writing (the second consecutive year of 20+% gains) and is on pace to mark the third-best annual return for the index since 2000. This impressive performance has been supported by several factors: the economy continuing to surprise to the upside, moderating inflation, and the Federal Reserve (Fed) beginning to ease monetary policy. Additionally, AI tailwinds within the mega caps continue to skew index returns higher. The question is, can this positive performance continue? We think yes, but believe that investors should dial back return expectations as 2025 will likely see more muted gains.

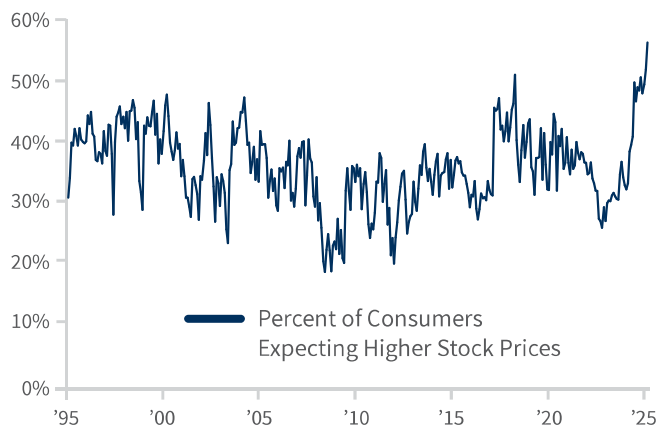
THE POWER & RISK OF EXPECTATIONS

Entering 2024, market expectations were low as investors were primarily focused on risks around inflation, the lagged impact of monetary policy, numerous geopolitical conflicts, and an uncertain economic outcome. For example, Wall Street strategists target estimates for 2024 coming into the year reflected only a 2% return! This pessimism allowed the market to surprise to the

Performance has been supported by several factors: the economy continuing to surprise to the upside, moderating inflation, and the Federal Reserve (Fed) beginning to ease monetary policy.

upside as these risks did not materialize to the extent expected. As we approach 2025, the situation has reversed. The market's perception of a possible recession has shifted to a soft landing, the consensus view on inflation is that it is no longer a significant risk, and economic growth has consistently exceeded expectations despite higher interest rates. Consequently, valuations and expectations have moved higher as risks have abated. In fact, consumers have never been this optimistic on the equity market, as 54% of consumers expect stock prices to rise over the next 12 months—the highest level on record! Looking ahead to 2025, markets may become more sensitive to these risks, potentially leading to a period of healthy digestion as estimates are recalibrated to sustain the bull market in the coming years.

Investor Optimism at All-Time Highs



Source: Factset, as of 11/30/2024

EARNINGS OUTLOOK FOR THE S&P 500

Consensus earnings estimates for the S&P 500 in 2025 appear somewhat optimistic. Specifically, the consensus expectations are for net margins to improve by 100 basis points (bps) to 13.4%, despite certain industries still facing a challenging macroeconomic environment. Our projections are more conservative, modeling a 60 bps year-over-year improvement in net margins for 2025.

Regarding sales growth, the consensus estimate of 5.7% seems fair to slightly conservative. Taking into account our economists' nominal GDP forecast of 4.9%, our model forecasts a slightly higher sales growth of 6%. However, this anticipated sales growth is unlikely to compensate for the shortfall in margins, as earnings per share (EPS) are more sensitive to changes in margins than to sales. Consequently, we are projecting EPS of \$270 for the S&P 500 in 2025, compared to the consensus estimate of \$274. This does not suggest that we are overly negative on corporate fundamentals, as our EPS forecast still represents a healthy 13% EPS growth versus 2024.

We expect earnings, rather than additional multiple expansion, to be the major driver of performance in the year ahead.

EARNINGS MUST DRIVE PERFORMANCE

Sentiment is a large driver of equity valuations. High expectations have justified the move higher in valuations during 2024 but could normalize slightly in 2025 as expectations moderate. After all,

how much more good news can the market price in—particularly in an environment where we see limited moderation in inflation and interest rates? We expect earnings, rather than additional multiple expansion, to be the major driver of performance in the year ahead. With earnings slightly outpacing price performance during the year, the trailing P/E multiple of the S&P 500 should moderate to ~23.5x by year end from 25.5x today.

The perceived positive market impacts from deregulation and taxes have outweighed potential negative impacts to profitability and inflation from tariffs.

However, we are not overly pessimistic about a steep correction in equity valuations. The sector composition of the S&P 500 Index has changed significantly over recent decades. Today, the index is heavily weighted toward Technology and growth-related companies with higher valuations, supported by superior fundamentals. While the valuation of the S&P 500 Index has moved higher over time, the earnings quality for the index has also improved materially. When adjusting equity valuations for improving Return on Equity (ROE), valuations appear only slightly above their long-term average. Additionally, valuations for the 'average stock' or the S&P 500 Equal Weight Index of only 17x reinforce the notion that equities are not broadly overvalued.

POLICY FATIGUE FOR EQUITY MARKET?

The S&P 500 has gained 4% since the election as markets applauded President-elect Trump's pro-growth agenda. However, we recognize that campaign promises do not always materialize during presidential terms. Tariffs, taxes, and deregulation have become the three largest policy-related focuses of the market. Thus far, the perceived positive market impacts from deregulation and taxes have outweighed potential negative impacts to profitability and inflation from tariffs.

Deregulation

A lighter regulatory touch should support economic growth while removing redundant layers of costs within public entities. The specific impacts vary widely by sector, with large, mid, and small-cap Financials seen as some of the largest beneficiaries. Lower regulation and less M&A scrutiny should support a gradual recovery in

capital markets activity. However, the exact impact depends on the true magnitude of the deregulatory efforts upon implementation.

Taxes

The potential tax policies under a Trump administration could have significant implications for both individuals and businesses. We believe an extension of current tax policy is nearly certain, while additional tax cuts will likely face higher hurdles that markets will grapple with in the year ahead. While this does not provide upside risk to earnings as it represents a continuation of current policy, the potential for higher taxes has diminished, which is positive for the equity market.

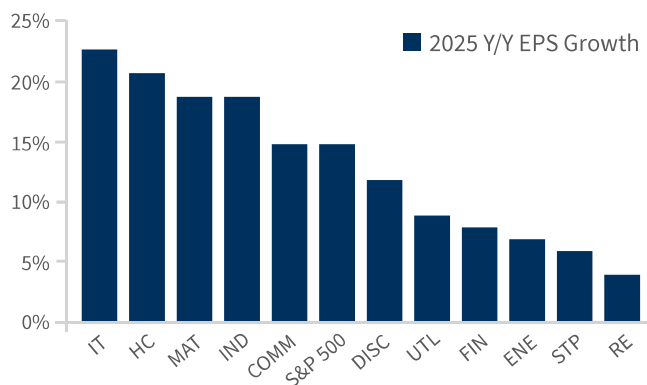
Tariffs

The impact of upcoming tariffs largely depends on the size and target of the tariff. At face value, tariffs could lead to pricing increases, which could contradict the Fed’s mission to return inflation to the 2% target. If businesses are unable to pass those pricing pressures along to consumers, it could also weigh on corporate profitability and margins. Markets have looked past the potential consequences of tariffs as they are seen as a negotiating tactic that may or may not end up being implemented.

FOCUS ON THE FUNDAMENTALS!

In an environment in which so much good news has been priced in, we are focusing on areas that have a longer-term favorable macro backdrop and also are supported by solid fundamentals. As a result, we continue to favor the Information Technology, Industrials and Health Care sectors. As such, these are three of the sectors that are expected to have some of the strongest earnings growth in 2025.

Our Sector Recommendations are Focused on Robust Earnings Growth



Source: Factset, as of 12/10/2024

Technology

The early innings of AI (artificial intelligence) remain a key theme in financial markets and a key driver of the 38% YTD return for the Technology sector. Corporate capex guidance implies technology spending should have another strong year in 2025. AI use cases are starting to broaden beyond the datacenter infrastructure investment and into the application phase across software and hardware. Superior fundamentals relative to the market (Tech is expected to see stronger earnings growth relative to the market in each quarter in 2025) should be enough for the Technology sector to sustain outperformance in 2025.

Industrials

Our overweight stance on Industrials is focused on supportive fiscal spending dynamics combined with exposure to key secular growth themes. On the fiscal side, less than 25% of recent fiscal spending bills (IIJA, CHIPS Act, IRA) has been spent, meaning that more than 75% of the spending still needs to be absorbed by the economy. Additionally, Industrials are poised to benefit from significant data center construction tailwinds as firms build out their AI infrastructure. We believe select Industrial industries, highlighted by electrical components, construction, and certain conglomerates, will drive outperformance during 2025.

Health Care

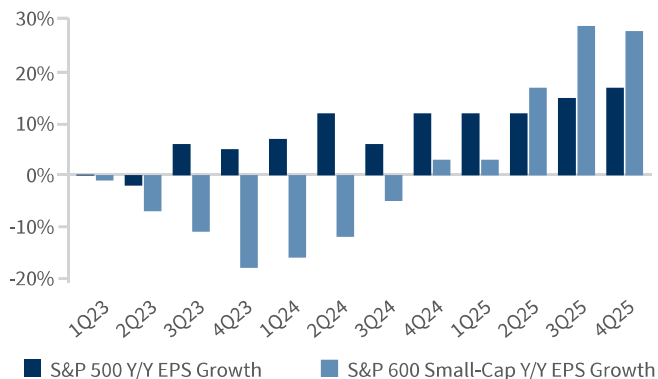
We have a contrarian view on the Health Care sector as overly negative sentiment driven by potential policy outcomes has driven valuations on a Price-to-Earnings to Growth ratio (PEG) basis to multi-decade lows. Attractive valuations, still positive demographic trends (e.g., aging population) and negative sentiment at a time when forward earnings estimates are stabilizing create a favorable setup as we move into 2025 and beyond.

Small Cap

We believe the market will continue to broaden in 2025, creating opportunities in small-capitalization equities. The valuations of small-cap equities relative to large-cap equities are near multi-decade lows at a time when small-cap EPS growth is poised to accelerate relative to large caps. This creates a favorable setup once forward earnings estimates trough.

Investors should prepare for a year of more measured gains, with earnings growth playing a crucial role in driving market performance.

Small-Cap EPS Growth Expected to Outpace Large Cap in 2Q25



Small-Cap Valuations Relative to Large Caps are Near Multi-Decade Lows



Source: Factset, as of 12/10/2024

BOTTOM LINE

As we look ahead to 2025, we believe the bull market will continue, albeit at a more moderate pace. The impressive gains of the past two years have set high expectations, and much of the good news is already priced in. While we anticipate continued economic growth and supportive market conditions, the potential for further upside may be tempered by these elevated expectations. Our target for the S&P 500 is 6,375, reflecting a valuation of 23.5x and our projected EPS of \$270. Investors should prepare for a year of more measured gains, with earnings growth playing a crucial role in driving market performance rather than additional multiple expansion. ■

2025 Outlook

	EPS	P/E	S&P 500 TARGET	PROBABILITY
Bull	\$280	25.5x	~7,000	35%
Base	\$270	23.5x	~6,375	50%
Bear	\$250	21x	~5,400	15%

Source: Raymond James Investment Strategy

KEY TAKEAWAYS:

- The S&P 500 gained ~27% as of this writing (the second consecutive year of 20+% gains).
- A surprisingly strong economy, moderating inflation, and the beginning of the Fed easing cycle were all supportive of equities.
- Earnings, not multiple expansion, will be the driver of performance.
- Investors should dial down their expectations as we expect returns to moderate.
- Our target for the S&P 500 is 6,375, reflecting a valuation of 23.5x and projected EPS of \$270.



Uneven Growth in an Uncertain World

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

The global economy will grow in 2025—a high degree of conviction in a world mired in uncertainty following President-elect Donald Trump’s victory, but outcomes will vary and become more dispersed. Outside the US the biggest improvement to global real GDP prospects will be in Japan and to a lesser extent the UK. In contrast, persistent structural headwinds will hamper the euro zone and growth will be lacklustre at best. Of the emerging markets, the Chinese economy will grow again but the pace will slacken as Beijing adjusts its focus away from the export sector and towards stimulating domestic demand. India has enjoyed a strong start to the decade and will remain the fastest growing major economy next year. Inflationary pressure, the focus of central bank policy measures over the past few years, will slowly normalise but with variance across differing geographical locations. This variance will manifest in a divergent approach to monetary policy between systemic central banks, with the Bank of Japan cautiously raising

interest rates while restrictive policy is loosened gradually elsewhere. For markets, the combination of moderate but still positive growth, subdued inflationary pressures, and supportive monetary policy is constructive for positive returns over the year ahead. Investors will, however, be mindful of the risks associated with a wide range of potential policy initiatives, market sensitivity driven by the substance, weight, and timing of measures which could deliver notably divergent investing outcomes.

The combination of moderate but still positive growth, subdued inflationary pressures, and supportive monetary policy is constructive for positive returns over the year ahead.

“ The global economy is expected to deliver real GDP growth of 2.7%, likely close to that achieved in 2024. ”

GLOBAL GROWTH WILL MATCH THAT OF 2024

Prospects for the global economy and markets outside the US are highly uncertain. Initially at least, President-elect Trump’s provocative rhetoric, particularly in relation to the imposition of trade tariffs on imported goods from ‘Day One’ following his inauguration, will garner most attention but the immediate impact could be fairly small. The global economy is expected to deliver real GDP growth of 2.7%, likely close to that achieved in 2024.



FOR CHINA THE DOMESTIC CHALLENGES TRUMP THE TARIFF IMPACT

The imposition of large tariffs on Chinese exports would damage the country’s export sector—but goods exports to the US amount to less than 3% of China’s GDP. Taking account of possible exchange rate weakness, some possible attempts at evasion (perhaps through re-routing exports via a third country subject to a lower tariff, such as Vietnam) and the redirection of manufacturing output to other destinations, the overall impact of even a 60% tariff could drop to less than 1% of GDP. The impact may likely be offset by lower interest rates and particularly fiscal policy expansion in part aimed at heading off the threat of insolvency in the Real Estate and Financial sectors.



EURO ZONE FACES PERSISTENT STRUCTURAL HEADWINDS

The direct impact of the threatened 10% tariff on all US imports, although an additional cost for exporters, would only amount to a fraction of a percent of euro zone GDP. However, the impact would be greater on Germany as the US is one of its key export

markets. The extent to which the region is impacted will depend on the extent to which tariff imposition might be diluted through negotiated concessions from the European Union as was the case in the automotive sector in 2018. Furthermore, exports to the United States account for only a small proportion of regional economic activity and the overall impact might be further diminished were the threatened 10% universal tariff applied to all countries, thus not placing the euro zone at a competitive disadvantage elsewhere.

That being said, indirect knock-on developments could impose a greater cost to the euro zone, notably a broader shift towards protectionism. Were Mr. Trump to press ahead with the threatened 60% tariff on China, European firms could experience even greater competition from Chinese manufacturers seeking to redirect exports away from the US. More generally, adjustments made in response to altered US trade policy come on top of structural challenges for Brussels including the need to spend more on defence at a time when national public finances are already stretched. The European Central Bank, already pivoting away from residual inflation concerns and towards propping up lacklustre growth will loosen monetary policy further. On top of that, President Christine Lagarde has revived the long-standing debate regarding the creation of a new Eurobond market which would, if it came to fruition, provide investors with a new, stable, and likely sizeable asset.

In the context of the uncertainty surrounding President-elect Trump’s trade policies, political turmoil in the euro area’s economic powerhouses, Germany and France, is the last thing an already embattled Brussels needs. Incumbent administrations have lost

The direct impact of the threatened 10% tariff on all US imports, although an additional cost for exporters, would only amount to a fraction of a percent of euro zone GDP

confidence votes, in no small measure associated with pre-existing domestic economic pressures and in the case of the latter a burgeoning fiscal deficit. Elections in Germany have been brought forward to February, while in France President M. Emmanuel Macron has been forced into appointing the country's fourth Prime Minister in under a year. With no major grouping in the National Assembly holding a majority and politicians in no mood to compromise there is little chance that France will achieve the fiscal consolidation necessary to put a deficit/GDP ratio of 6% on a sustainable footing. The uncertain outlook has caused credit agency Standard & Poor's to cut its rating an additional worry for investors already perturbed by a widening spread between French and German bond yields.

Although the political situation in Germany is less fraught, the election will not turn the ailing economy's fortunes around. Having broadly stagnated since the pandemic, a worse outcome than that experienced by its regional peers, the outlook remains poor. A weak labour market is depressing consumption, employment growth has stalled and will likely go into reverse in part the consequence of automotive giant VW's plans to shutter three manufacturing plants for the first time in its long history. Meanwhile industrial output has slumped and with order books at depressed levels a near-term turnaround is unlikely. The export sector on which the German economy has come to rely is under pressure, producers are already reporting a loss of international competitiveness and that without the US tariff threat. A turnaround could be achieved through a loosening in the country's strict fiscal rule, the so-called 'debt brake', but political parties are keeping their cards close to their chest as potential bargaining chips in likely post-election coalition talks.



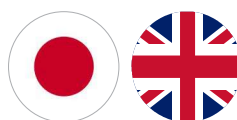
DIVERGENT PROSPECTS FOR EMERGING MARKETS

Turning to emerging economies and potentially very divergent prospects for the two economies thought likely to bear the brunt of a more isolationist USA: the Mexican economy appears most vulnerable. Not only are the country's public finances in poor shape already, but a stronger dollar would also likely limit the scope for policymakers to counter the impact of tariff implementation through fiscal or monetary policy support. In contrast, South Asia might prove a net beneficiary. Certainly, the imposition of a universal 10% tariff would not be consequence free but if accompanied by a 60% tariff on Chinese goods export it could allow regional producers to gain market share and encourage inward investment.

Such a development would be beneficial to Vietnam. The Indian stock market has given up some ground after a stellar start to the decade. Despite a still favourable macro backdrop, equity valuation fully reflects this, and a Trump presidency (strong dollar) would tighten financial conditions imparting a headwind to upside progress in so doing.

SUPPLY CHAINS

In a world in which supply chains can be long, complex and where component parts often cross borders numerous times during their assembly, the impact of tariff imposition broadens potentially engulfing US manufacturing firms too. Businesses thought protected by the introduction of tariffs on competitive imports would still be forced to pay higher imported input costs. Additionally, any drop in US imports could trigger a drop in exports of US-produced parts used in the manufacture of goods overseas.



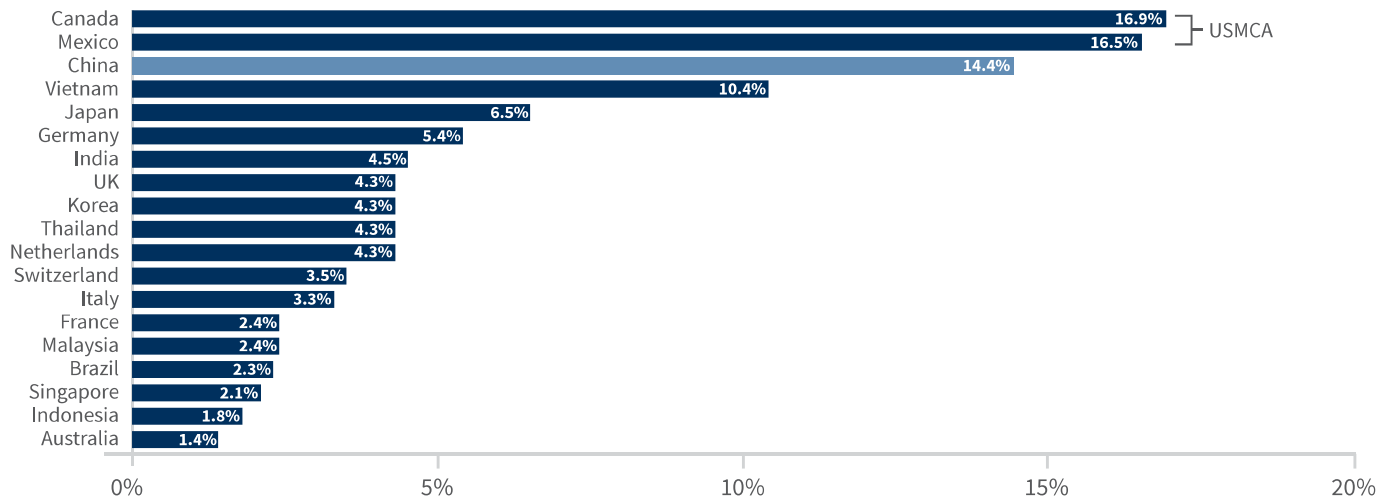
JAPAN AND THE UK

If China is no longer to be the United States' 'Most Favoured Nation,' might that mantle shift to Japan? Whilst standing ready for tariff imposition, Japan's free trade agreement with the US may mean its economy gets off lightly. Note that Japan sees itself as a good partner to the US, with total investment hitting \$783 billion (15% of total cumulative foreign direct investment into the US in 2023). This may not be good enough for the Trump administration given Japan's economic relationship with China. Facing long-term structural headwinds of its own, a contrite (and unstable) minority ruling coalition has agreed to a JPY 13.9 trillion (\$92.4bn) supplementary budget containing stimulus measures aimed at reflating the economy through increased consumption. This would add 0.6% to real GDP growth in 2025 alone, through increased consumption and public works spending and further expansionary fiscal policy measures cannot be ruled out.

Other than pharmaceutical products and automotive exports, the UK economy is not generally exposed to the imposition of US import tariffs. Goods trade between the two economies is broadly in balance and although the UK runs a trade surplus with the US in services of £69bn (2.5% of UK GDP, 2023) Mr Trump's desire to improve the fortunes of US manufacturing above all else implies that the UK should escape fairly lightly (+/- 0.1% GDP in 2025). More pertinently, Finance Minister Rachel Reeves' budget focuses on investment to boost the UK economy's longer term productive

US Goods Imports by Country

Proposed tariffs may have uneven impacts on US trading partners.



Source: FactSet, data as of 10/31/24

Governments around the world are adjusting to prepare for a more isolationist US administration.

potential. The policy may work, but only over time and likely with the support of the Bank of England which, in common with the Federal Reserve, is expected to cut interest rates only very gradually over 2025.

CONCLUSION

From Brussels to Tokyo and Taipei to Kyiv, governments around the world are adjusting to prepare for a more isolationist US administration led by a president who sees diplomacy in purely transactional terms. The challenges confronting the world are that much greater in an economic system being reshaped by the fracturing relationship between the US and China, a process Mr. Trump did so much to accelerate during his first term of office. Most of all, the return of President Trump and his newly forged cabinet will result in a more uncertain global policymaking environment. The shift in attitudes both towards Beijing and Washington will be the defining legacy of 2025, initiating a potentially profound adjustment in the global economic order. ■

KEY TAKEAWAYS:

- The global economy will grow at a pace close to that achieved in 2024.
- The direct impact of tariff implementation will be quite small but the indirect impact will be greater and more persistent.
- Inflationary pressures will slowly subside to target allowing room for central bank policy loosening.
- Beijing faces two challenges, to offset aggressive tariffs on exported goods to the US and address the growing solvency crisis in its real estate and financial sectors.
- Tokyo's efforts to reflate the Japanese economy will deliver a cyclical revival. The Bank of Japan will deliver limited rate hikes.
- Goods trade with the UK is broadly in balance. The focus for the UK economy will be on Finance Minister Reeves' ability to raise productivity and growth. Bank of England policy will be broadly supportive.
- The macro backdrop is consistent with positive returns from financial market assets, but prospects will vary across differing geographic locations.

Economic Snapshot

The inflation discussion will remain front and center next year but especially during the second half of the year as the disinflationary process comes to a standstill. Furthermore, economic growth is poised to continue to outpace expectations and that will add to the inflationary concerns going forward. Despite a cooling labor market, employment remains positive, and we expect it will moderate around its 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 IRA and CHIPS Act continued to support business spending but we expect these effects to continue to lessen and provide less of a tailwind to economic activity. We expect the Federal Reserve to reassess the economic environment as well the interest rate environment allowing the institution to bring down the rate of inflation to its 2.0% target over the long term. Although rates are probably going to remain higher for longer, the manufacturing sector should strengthen somewhat once all the investments in new plants brought about by the legislative boost start to produce increased output. Geopolitical uncertainty around the world remains elevated, which, together with interest rate differentials, should be beneficial to the strength of the US dollar.

EUGENIO J. ALEMÁN, PhD
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	GDP growth is expected to continue to remain relatively strong in the first quarter of the year, but overall growth is expected to slow for the whole year compared to 2024.
	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 short term.
NEUTRAL	EMPLOYMENT	The labor market has been cooling and we expect it to weaken further but to stabilize around its long-term average.
	CONSUMER SPENDING	Consumer spending will continue to slow down, with lower-income households struggling to pay their credit cards as higher prices continue to take a toll and the labor market softens.
	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 Investment and Jobs Act (IIJA) are contributing positively to business investments.
	MANUFACTURING	The US manufacturing sector will continue to struggle in 2025 as high interest rates continue to affect the sector. However, investment in the sector brought about by the IRA, the CHIPS Act and the IIJA, will help the sector see some recovery at the end of 2025, early 2026.
	HOUSING AND RESIDENTIAL CONSTRUCTION	High mortgage rates and rising construction costs have kept this sector in contraction for several quarters. Low inventory of homes has kept upward pressure on prices. Although lower mortgage rates will help the sector, the new path for Fed cuts may keep the sector from experiencing a strong comeback.
	INFLATION	Inflation has remained sticky, but it is likely to continue its disinflationary trend as economic activity weakens over the next few quarters. Shelter costs should continue to slow, and with energy prices negative on a year-over-year basis, inflation should continue to decline.
	MONETARY POLICY	The Fed started its easing cycle in September, and we expect it to cut rates 50bps in 2025 and in 2026, taking the federal funds rate to 3.75-4.00% at the end of 2026.
	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.
	FISCAL POLICY	With continued investment through the Inflation Reduction Act (IRA) and CHIPS Act plus a potential extension of the tax cuts implemented in 2017, the fiscal deficit issue is expected to remain a politically hot topic.
	REST OF THE WORLD	We continue to expect a relatively weak global economy in 2025 despite central banks worldwide turning more dovish.

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. Our goal is to look for trends that can be sustainable for several quarters; yet given the dynamic nature of financial markets, our opinion could change as market conditions dictate.

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

Equal Weight: expect in-line relative performance

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

For a complete discussion of the sectors, please ask your financial advisor for a copy of *Portfolio Strategy: Sector Analysis*.

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	INFORMATION TECHNOLOGY	32.4%	We maintain our Overweight stance on Technology as AI investment should continue to propel earnings going forward. AI-related capex is expected to remain strong through 2025 which supports first derivative beneficiaries (semiconductors) and monetization has begun to broaden into second derivative beneficiaries (cloud, software applications, and hardware devices). Any short-term consolidation should be viewed as an opportunity to build positions in this multi-year innovation cycle.
	INDUSTRIALS	8.2%	Supportive fiscal spending dynamics (~75% of spending to IRA, CHIPS and Science Act, and IJIA remains to be spent), reshoring of global supply chains, and fixed investment in data centers driven by AI should outweigh cyclical headwinds enough to mark an earnings trough into 2025. Our Overweight stance is focused on direct beneficiaries of these factors including conglomerates, electrical components, and construction.
	HEALTH CARE	9.9%	Overly negative sentiment and attractive valuations create a favorable contrarian setup over the next 12 months. Forward earnings estimates have stabilized and begun to inflect higher after suffering from negative revisions over the last 2 years driven by post-COVID normalization. The sector PEG ratio (1.2x) is among the most attractive of all sectors and Health Care historically outperforms in the year following a presidential election once policy uncertainty is removed. 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.
EQUAL WEIGHT	COMMUNICATION SERVICES	9.5%	The outperformance of Communication Services has been supported by relative earnings strength driven by robust digital ad spending and significant efficiency initiatives (e.g., cost cutting). However, the sector has become highly concentrated with mega-cap tech representing ~70% 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.
	FINANCIALS	13.3%	Improving CEO confidence and any deregulatory efforts by the upcoming administration should support a gradual recovery in investment banking activity within capital markets and banks. However, at over 2x book value, valuations within the sector are already discounting a material recovery in fundamentals which creates downside risk if the economy weakens further than expected or if anticipated deregulatory efforts fall short of market expectations.

EQUAL WEIGHT	CONSUMER DISCRETIONARY	11.7%	Mega-cap exposure within the sector has been the main driver of sector performance while legacy Consumer Discretionary names (e.g., retail) remain challenged by a discerning consumer. We upgraded the sector to neutral during the quarter as the mega caps should continue to offset weakness in other areas of the sector over the next 12 months.
	CONSUMER STAPLES	5.6%	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.
	ENERGY	3.1%	Potentially higher US oil production as a result of policy shifts by the incoming administration, alongside the unwinding of OPEC+ production cuts, is likely to limit the upside to energy prices over the next 12 months. Additionally, protectionist trade policy will likely lead to a firm USD which is a net negative for most commodities including oil. Attractive valuations (13x 2025 earnings with an 8% FCF yield) combined with shareholder-friendly capital allocation strategies (3.5% dividend yield and 4% buyback yield) should support healthy total returns.
UNDERWEIGHT	UTILITIES	2.2%	Despite AI driven tailwinds to long-term power demand, we remain underweight Utilities—always a rate-sensitive sector—given our expectation that Treasury yields will remain on par with current, elevated levels in 2025. 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.
	REAL ESTATE	2.1%	We don't see much room for outperformance from the sector without a material decline in interest rates. Sticky inflation combined with resilient US economic growth creates a slight upside risk to rates from current levels over the next 12 months. Weak earnings trends and ongoing challenges in commercial real estate urge patience with the sector.
	MATERIALS	2.0%	A slowing global economy, particularly in China, along with a firm USD 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.

Disclosure

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

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

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

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

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

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

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

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

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

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

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

The process of rebalancing may result in tax consequences.

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

The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence.

The indexes are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Shanghai Composite Index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

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

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

The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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