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INVESTMENT STRATEGY QUARTERLY



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China:

Global perspectives on change and challenge

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Ryan Lewenza, CFA, CMT, *Senior Vice President, Private Client Strategist and Portfolio Manager, Raymond James Ltd.**

Chris Bailey, *European Strategist, Raymond James Euro Equities**

A U.S. PERSPECTIVE

— Scott J. Brown, Ph.D.

China has been a key concern for investors in recent months. The country's stock market correction and currency adjustment added to market volatility worldwide. After the Shanghai Composite Index more than doubled in a year, the decline in share prices appears to be the unwinding of a speculative bubble. The currency decline was not intended to be a competitive devaluation. Rather, it was an ill-fated attempt to move to a more market-driven exchange rate. China's leaders want the Yuan to be seen as one of the world's key reserve currencies. The International Monetary Fund ("IMF") was reported to be considering whether to add the Yuan to its benchmark basket (along with the dollar, pound, Euro, and Yen). However, to do so would require that the exchange rate be set by the market, rather than at the whim of Chinese officials. This exchange rate experiment didn't last long, as the currency fell sharply in just two days, and officials declared the adjustment to be "essentially complete." These developments were a sideshow, however, to the more important issue, which is slower growth.

China is making two difficult and potentially dangerous transitions. The first is that the economy needs to transform from one being led by export growth and infrastructure spending to one being led by consumption. That will take some time and growth could be bumpy along the way. Moreover, sustainable growth at the end of the transition is likely to be slower. China's growth has averaged about 10% per year over the last couple of decades, but may slow to 4-6% in the years ahead.

The second is the liberalisation of China's capital markets. Asset prices need to be determined by the markets, with limited intervention from the government. History has shown that if such a transition is not carefully coordinated, there can be severe consequences. The

government's clumsy efforts to prevent share prices from falling and to keep its currency from weakening too rapidly illustrate the difficulties and have undermined confidence.

SCOTT BROWN
Chief Economist,
Equity Research

What would a slowdown in China mean for the U.S. economy? Not much directly. China accounted for a little over 7% of U.S. exports in 2014, less than 1% of GDP.

What would a slowdown in China mean for the U.S. economy? Not much directly. China accounted for a little over 7% of U.S. exports in 2014, less than 1% of GDP. However, China has been a major importer of raw materials and many commodity exporters, such as Australia, Brazil and Canada, are seeing weakness. So, slower growth in China will have broad effects on the global economy.

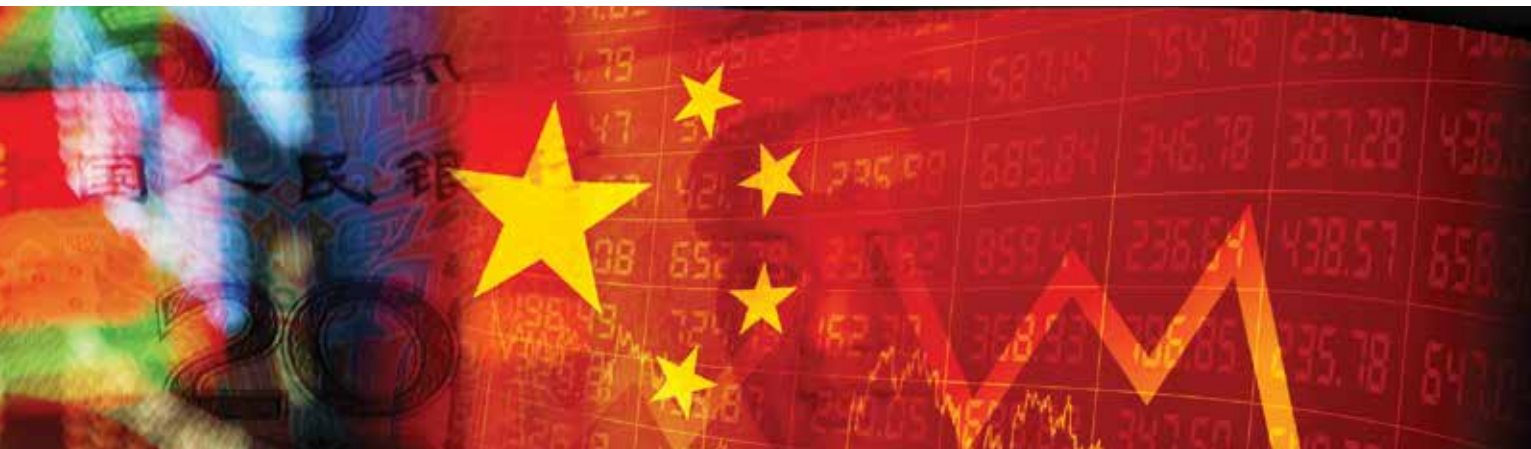
It's not all bad news. Lower commodity prices, especially the drop in oil prices, should be beneficial to U.S. consumers and businesses. That should add to

domestic strength in the months ahead.

A COMMODITY MARKET PERSPECTIVE

— Ryan Lewenza

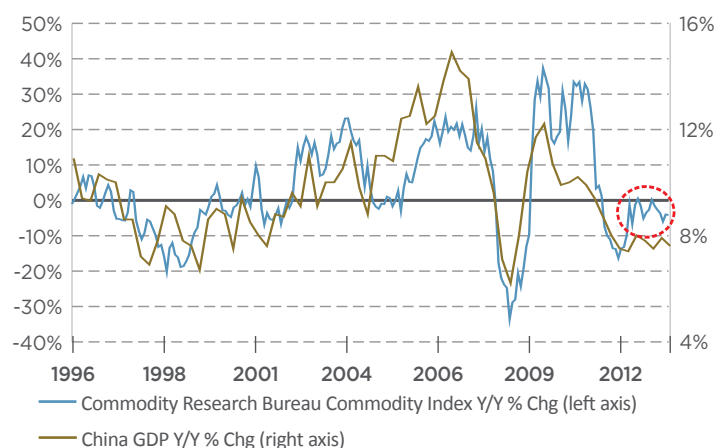
China's economic growth and commodity prices are inextricably linked. We often say that "China is the marginal price setter of commodities." We say this for a number of reasons. First, the combination of China's large population, rising standards of living, and urbanisation has led to an insatiable demand for commodities. Second, related to this point, China represents roughly 50% of annual global demand for key commodities like steel, cement, and copper among others. Third, China has been investing in infrastructure at an incredible rate, building roads, airports, and high-speed rail, to support the continued urbanization and growth of the country. To put this into context, China's investment as a percentage of GDP is 51%, compared to the U.S. at 17%. While some of these investments were surely dubious (i.e., China's ghost cities), many of these investments were critical in the advancement and growth of the nation. Finally, as the saying goes "a



COMMODITY PRICES MIRROR CHINA'S ECONOMIC GROWTH

picture is worth a thousand words.” In the adjacent chart, China’s GDP growth is overlaid with the year-over-year change in commodity prices. Note the high correlation between the two. As China’s growth accelerated, commodity prices rose, and as China has slowed, commodity prices have come under pressure. Putting it all together, it becomes clear that the outlook for China will largely drive the outlook for commodities. And on that, it should come as no surprise that as China’s GDP growth has slowed from an average of 9.4% in the 2000s to 7% in 2015, that demand for commodities has waned, and prices have fallen.

The question then is “what is the outlook for China’s growth?” China is currently undergoing a massive transformation. This transformation in part explains the deceleration of economic activity. The other key drag



Source: Bloomberg

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

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China

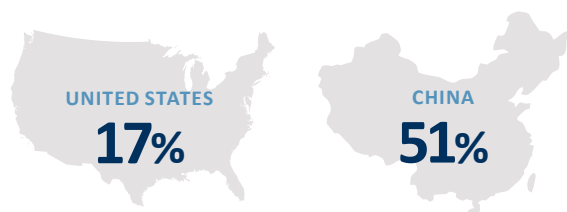
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on economic growth has been the notable decline in export growth. Following China's inclusion in the World Trade Organization in 2001, real exports rose at a staggering 25% per year until 2007. Since 2014, real export growth has slowed significantly to 3.5%. Our view is that while China should avoid a hard landing, economic growth should continue to slow, possibly to a more sustainable mid-single digit growth rate.

REASONS WHY CHINA IS THE MARGINAL PRICE SETTER OF COMMODITIES

1. The combination of China's large population, rising standards of living, and urbanization has led to an insatiable demand for commodities.
2. China represents roughly 50% of annual global demand for key commodities such as steel, cement, and copper, among others.
3. China has been investing in infrastructure at an incredible rate, building roads, airports and high-speed rail, to support the continued urbanization and growth of the country.
4. As China's growth accelerated, commodity prices rose, and as China has slowed, commodity prices have come under pressure.

INVESTMENT AS A PERCENTAGE OF GDP



Given this slowdown, we have maintained a cautious view of commodities, which is one factor in our recommendation to underweight the materials sector. It is also why we continue to recommend to our Canadian clients to look outside of Canada more, focusing on the better-positioned U.S. and European equity markets.

A EUROPEAN PERSPECTIVE

— Chris Bailey

“When written in Chinese, the word ‘crisis’ is composed of two characters. One represents danger and the other represents opportunity” - John F. Kennedy

Europe's economic revitalisation strategy over the past couple of years has been as much about stimulating exports via a low Euro as it has been about expanding unorthodox monetary policy via quantitative easing and other support measures. A by-product of this has been the rapid build-up in the share of exports to emerging markets as a percentage of European countries' GDP. Last year, German exports to emerging markets were equivalent to over 10% of their GDP and for the broader Euro area, just over 8% of regional GDP. By contrast, the equivalent statistic for the U.S. is 4%. Unsurprisingly, the majority of demand for European exports comes from China.

The current Chinese economic challenges are therefore poorly timed for European economies as it lessens one of the positive growth drivers for the region and therefore places more emphasis on local regional drivers. Given we have previously chronicled challenges with coordinating pan-European stimulus and structural reform policies, this development is a headwind for European growth levels. Earlier in the month, the President of the European Central Bank, Mario Draghi, reduced expectations for 2015-17 Euro area growth, citing the challenging global backdrop. There is little doubt that the combination of a Chinese slowdown and a disappointing application of European



structural reform initiatives has impacted this action. Little wonder that rumours about a second wave of quantitative easing in Europe have heightened.

Out of danger, however, comes opportunity. Policy makers – especially in the Euro area – seem more enthused by crisis moments. Europe probably needs a second (or extended) dose of quantitative easing support and it certainly needs structural reform initiatives that improve the region’s flexibility, dynamism and competitiveness. A Chinese slowdown should boost the likelihood of both events. The most difficult aspect to predict is timing. The fastest agents of change are once again likely to be individual companies rather than governments and that should support a more thematic or specific investment approach to European assets versus a more blunt index-wide approach.

Europe’s trade links with China remain a medium-term tailwind rather than a headwind as the ending of recent over-reliance on the Middle Kingdom’s economic development can actually be turned into an impetus for further required European reform. In the meantime, it also implies the announcement of a further slug of quantitative easing support, making the economic and financial policy-making debate in the region a continued differentiator from current policy in the United States. ■

KEY TAKEAWAYS:

- A slowdown in China would not mean much for the U.S. economy directly. China accounted for a little over 7% of U.S. exports in 2014, less than 1% of GDP.
- Putting it all together, it becomes clear that the outlook for China will largely drive the outlook for commodities.
- Given the slowdown in China, we have maintained a cautious view of commodities.
- Europe’s trade links with China remain a medium-term tailwind rather than a headwind as the ending of recent over-reliance on the Middle Kingdom’s economic development can actually be turned into an impetus for further required European reform.

The Migrant Crisis: European Political and Financial Markets

Chris Bailey, *European Strategist, Raymond James Euro Equities**

Europe – and in particular the Eurozone - has a well-documented growth problem. Recently the Chief Economist of the European Central Bank (ECB) Peter Praet observed in a speech that since the first quarter of 2008 the Eurozone's cumulative growth rate was a full 13 percentage points less than the level achieved by the United States.

Growth comes from many sources but typically economists focus on four factors: land, labour, capital and an entrepreneurial or dynamic spirit. In a modern advanced economy much focus is centred on the cost or availability of capital plus encouraging a flexible and risk-taking environment.

However, breaking down the underlying drivers to economic growth and the quantity and quality of labour becomes very important.

Populations around the world are ageing but none more so than in Europe where the proportion of persons aged 80 or over among the total population is expected to more than double, from just over 5% in 2014 to more than 12% by 2080. Therefore the side effects of war, political/economic uncertainty and a general desire for a better life, which has induced around 700,000 migrants so far this year to attempt the often perilous journey to Europe's borders from the Middle East and Africa, could be perceived as offering a solution for the region's demographic challenges.

So far the 'migrant crisis' has just highlighted one key aspect: Europe's political and decision-making disunity. Following attempts by the German Chancellor Angela Merkel to try and co-ordinate national migrant quotas for individual countries around Europe ("We can bear the costs of accepting the refugees"), newspaper stories during September included choice headlines like 'Eastern EU states fight migrant "diktat"' and 'Hungary's prime minister accused Germany of "moral imperialism"'. Clearly any potential medium-term economic benefit is rubbing up against shorter-term political challenges.

Political disenfranchisement is rising across Europe – as witnessed by falling participation ratios and a rise in the amount

of votes for non-traditional mainstream parties. At the heart of this discontent are the lower growth rates noted above.

This appears paradoxical or at least short-sighted. In reality it reflects the fear of change that is currently so prevalent across Europe (and much of the advanced world). As old certainties fade away, reactionary tendencies can fester and grow especially under weak political leaderships.

FIRMS HAVING DIFFICULTIES FILLING JOBS (%) IN 2015

Hungary	58%
Germany	46%
Poland	41%
Sweden	39%
France	28%
Slovenia	27%
Czech R	18%
UK	14%
Holland	14%
Spain	14%

Source: Manpower, Eurostat, UN



And this is why Mrs Merkel's stridently positive tone is of huge interest. Germany may be Europe's richest and most successful economy over recent decades and therefore in the best position to finance the inevitable shorter-term expenditures associated with mass migrations. The labour force factor of production influence on economic growth is genuinely positive but not typically immediately.

Where have we heard similar shorter-term versus longer-term commentary issues before in Europe? Discussions on bail-outs and debt assistance for a number of European peripheral countries over recent years share a similar tone, with a longer-term focused Germany arguing against the moving too far down (in their view) of the slippery slope of region-wide debt risk sharing or debt write-down.

How do we square such opinions? The answer lies in national interest. Just as Germany in its role as Europe's richest and least indebted economy is cautious about contributing too much to others debt burdens, at the same time it is acutely aware of the longer-term opportunity for its own ageing economy by welcoming numerous migrants.

Beyond the often heart-breaking humanitarian story, the migrant crisis could be turned by Europe into an opportunity and not a threat. However what it has highlighted is again the challenges of blending together national and pan-regional interests across the European continent with knock-on effects for confidence, economic growth, stock market valuations...and potentially the lives of many displaced people. ■

POPULATION % CHANGE 2015-35 ESTIMATED

Hungary	-8%
Poland	-6%
Slovenia	-3%
Germany	-3%
Czech R	-2%
Spain	-1%
Holland	4%
France	7%
UK	10%
Sweden	13%

Source: Manpower, Eurostat, UN



The Fed:

Delayed but not forgotten

Scott J. Brown, Ph.D., *Chief Economist, Equity Research*

The Federal Reserve has not raised short-term interest rates since June 2006. The U.S. central bank last lowered the target range for federal funds (the overnight lending rate) to 0-0.25% in December 2008 and has kept it there since. The economic recovery, now more than six years along, has made substantial progress. U.S. job growth has been strong in the last couple of years and slack in the labour market has been reduced considerably – with further slack expected to be removed over the next year. Fed officials need to set monetary policy based on where the economy is expected to be 12 to 18 months ahead. Hence, it is appropriate for policymakers to consider embarking on a gradual normalisation. The first step is to raise the federal funds target range.

Fed officials believe that the precise timing of the initial move should not be important. What matters is the pace of tightening, and officials expect rate hikes to be very gradual. However, financial market participants believe that timing matters a lot. Recent signs of softness in emerging-market economies suggest that the global economy may be fragile and that a Fed rate hike could make conditions worse, adding to recent market volatility. The Fed's focus is clearly on the U.S. domestic economy, which appears to be in good shape, but officials do need to take into account how overseas reactions to Fed action might influence things in the U.S.

DOUG DRABIK
Senior Strategist, Retail
Fixed Income

The decision is not so easy given all the data that contests the policy. The Fed has extended a very open and accessible policy and will likely raise by year end; however, there are compelling reasons to think they will not have too many consecutive or significant increases.

If this sounds vaguely familiar, it's because we went through a similar situation in 2013. At that time, the Fed was in the middle of its third large-scale asset purchase program, also known as QE3. The Fed was contemplating reducing the current monthly pace of \$85 billion in asset purchases, but it couldn't stop all at once and decided to taper the rate of asset purchases over time. Simply mentioning the reduction in the pace of purchases sent financial markets into a "taper tantrum." Bond yields rose, emerging economies experienced financial strains, and the Fed ultimately

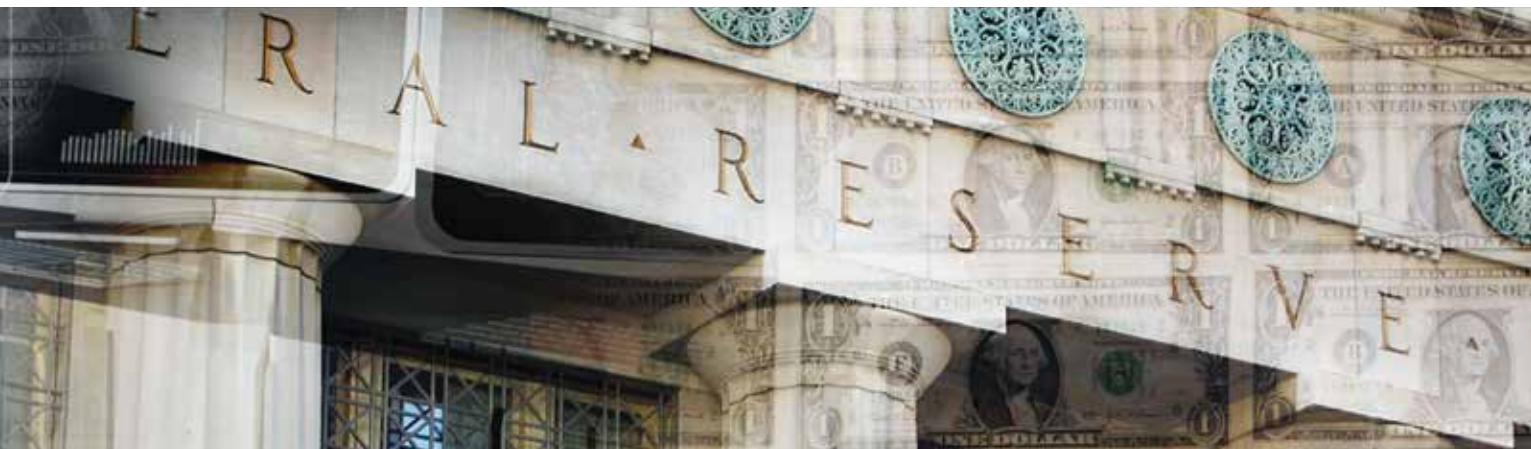
delayed, but did not permanently postpone, its tapering of QE3.

This time around, bond yields haven't taken off, but stock market participants here and abroad are still nervous. If not for the recent global financial volatility, the Fed would likely have begun raising short-term interest rates in September.

Why raise rates? The Fed would not be hitting the brakes so much as starting to take the foot off the gas pedal. Inflation isn't really a problem. The strong dollar and lower commodity prices put downward pressure on consumer price inflation in the near term, but the Fed views that as transitory.

Oil prices won't fall forever and should stabilize. The dollar has been range-bound against the major currencies since March, but has rallied sharply against other currencies in recent months. Those currencies accounted for 57% of U.S. imports in 2014. A rate increase would boost the dollar somewhat, adding downward pressure on inflation, but much of that may already be priced into the markets.

The labour market is the widest channel for inflation pressure. Wage growth has remained lacklustre, but should eventually



pick up as the job market improves further. A number of Fed officials have been surprised that we haven't seen strong wage growth, given the drop in the unemployment rate and strong pace of growth in nonfarm payrolls over the last year. There may be a number of factors (for example, the decline in union power or the ability of firms to cast a wider net when hiring) that are limiting wage pressures.

Fed officials are divided on the perceived risks. The "hawks" always seem to see inflation around every bend and want to tighten sooner rather than later. The "doves" see few signs of upward pressure in inflation in the near term and are more concerned with signs of slack in the labour market. Monetary policy will still be very accommodative even after the first few Fed rate hikes.

While global concerns may delay the Fed's initial rate increase, it won't postpone it permanently. As Fed Vice Chair Stanley Fischer put it in late August, by meeting the Fed's objectives (low inflation and maximum sustainable employment), "and so maintaining a stable and strong macroeconomic environment at home, we will be best serving the global economy as well." ■

KEY TAKEAWAYS:

- Fed officials believe that the precise timing of the initial move should not be important. What matters is the pace of tightening, and officials expect rate hikes to be very gradual.
- The Fed's focus is clearly on the domestic economy, which appears to be in good shape, but officials do need to take into account how overseas reactions to Fed action might influence things in the U.S.
- Monetary policy will still be very accommodative even after the first few Fed rates hikes.



Oversupply:

Not just oil's problem anymore

Q&A with Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research

Q: U.S. and international oil stockpiles are near record highs. Why is the market so saturated on the supply side?

A: There are three fundamental reasons why the physical oversupply of oil is so visible globally. First, Saudi Arabia's oil production is running at record-high levels, up 7% year-on-year, as it continues its price war with non-OPEC producers such as the U.S., Russia, and Brazil. Saudi behaviour is starting to become irrational, and of course it cannot keep worsening the oil glut forever. However, as things stand, we have to assume that its record production will continue into 2016. Second, Iraq's production has soared – which may seem counter-intuitive, given the ongoing headlines about the war with ISIS. On a percentage basis, Iraq stands out as the fastest-growing major oil producer of 2015: up more than 15% year-on-year, ahead of most expectations. Third, non-OPEC oil supply – which is two-thirds of the world total – hasn't yet begun to exhibit significant declines. To be clear, this will eventually happen, given the extent to which the entire industry is in austerity mode, but it will likely be the second half of 2016 before the non-OPEC declines become meaningful.

Q: What will ultimately trigger price recovery in the oil market, and do you see volatility being a common theme going forward?

A: It is overwhelmingly supply that is the culprit behind the oil sell-off. The 2015 global oil demand picture (up 2%) looks much better than we would have predicted a year ago. So it is supply that will have to "fix" the oil market. The quickest solution would be for Saudi Arabia to ease off on its overproduction, because – let's be honest – it is already winning the price war. But if that does not happen, then it may take 12 to 18 months to rebalance the market via a decline in non-OPEC supply. Across non-OPEC countries, we are seeing huge declines in oil and gas investment, drilling activity and project

There is no escaping the fact that volatility will persist.

approvals. This will gradually trigger a supply response – so much so, in fact, that it's even possible to imagine points of time towards the end of this decade when the oil

market might be under-supplied, especially in the event of geopolitical supply disruptions. In the meantime, however, there is no escaping the fact that volatility will persist. The negative economic headlines from China, for example, spurred a dramatic downturn in equities and commodities alike – even though the actual impact on Chinese oil demand is small. On the other hand, in late August, oil prices had their biggest three-day gain since 1990 amid rumours that OPEC might be rethinking its production strategy.

Q: What about natural gas? Is it looking better or worse than oil?

A: Unlike oil, there is no such thing as a global market for natural gas. North America is a single gas market, but Europe consists of three separate ones, and Asia-Pacific countries also have different gas price dynamics. It is well understood that oversupply of shale gas in North America has pushed prices to historically low levels, but what's less well known is that international gas economics are also starting to look more bearish. Case in point: European gas demand has had a stunning fall to a 20-year low, due to a combination of more wind and solar as well as cheap coal. Europe still relies, to a large extent, on buying gas from Russia, but its falling consumption means imports are down. In Asia, gas demand is growing, but not as fast as the industry would have hoped. In the meantime, Australian gas exports are ramping up, and for the first time, the U.S. Gulf Coast will be exporting some gas to Asia in 2016. Thus, we cannot blame OPEC for the weakness in gas prices worldwide, but



rather it's an issue of structural changes in both supply and demand.

Q: Why are agricultural commodity prices so low, and who are the winners and losers?

A: Many investors tend to be more familiar with what's happening in energy and metals as compared to the agricultural sector. While they don't always trade in parallel, over the past year we've seen close correlations among just about all commodities. In the case of the main staple crops – corn, wheat, soybeans, sugar cane – prices are at or near the lowest levels since the global financial crisis of 2008-2009. As of July, for example, the United Nations' global food price index was down 19% year-on-year. Part of the reason is ample supply. Favourable weather in the Midwest has boosted U.S. output and exports, though the strong dollar has been a headwind. In Russia and Ukraine – and, to a lesser extent, Brazil – weak currencies are enabling especially cheap exports. Meanwhile, Chinese demand has not been as robust as expected – as is true of all commodities – leaving global stockpiles at elevated levels. Low energy prices are also helping by reducing the cost of fertilizer and transportation. All this is great news for countries that depend on imported food: for example, China, Japan and Egypt. On the flip side, farmers in the top food exporters – the U.S. and Canada, much of South America, and Russia – are feeling the pressure of lower revenues. ■

KEY TAKEAWAYS:

- It is overwhelmingly supply that is the culprit behind the oil sell-off. So it is supply that will have to “fix” the oil market.
- There is no escaping the fact that volatility will persist.
- Over the past year we've seen close correlations among just about all commodities. In the case of the main staple crops, prices are at or near the lowest levels since the global financial crisis of 2008-2009.



Turn Off The Noise:

Are we back to “normal” volatility?

Kristin Byrnes, *Committee Vice-Chair, Product Strategy Analyst, Wealth, Retirement & Portfolio Solutions*

WHAT HAPPENED LAST QUARTER?

June 12, 2015 marked the beginning of a significant correction in China’s stock market which spanned most of the summer months. Despite several attempts by the Chinese government to halt the sell-off, the Shanghai Composite Index lost nearly 43%, peak-to-trough. Roughly two months later, on August 17, the Dow Jones Industrial Average embarked on a more muted correction, losing 10% over the course of seven consecutive trade days.

Further complicating matters for China, government officials made a surprising move by devaluing the Yuan, China’s national currency. Chief Economist Scott Brown, Ph.D. explains the failed experiment: “They were not trying to boost exports by weakening their currency. What they were trying to do was move towards a free-floating currency - to have a market-based determination of the exchange rate.” What was actually an attempt to implement positive structural reform quickly turned into a misinterpreted signal by investors that further economic slowdown was to be expected.

General consensus believes that recent market activity, while unpleasant, is a healthy correction and a normal part of the equity market cycle.

WHERE ARE WE NOW?

The Shanghai Composite Index continues to display heightened volatility, yet remains up around 30% over the last year, as of late September. Brown makes an important point, noting that, “China’s stock market decline is not really indicative of economic weakness, nor is it necessarily going to cause economic weakness. That said, Chinese growth has slowed.” European Strategist Chris Bailey opines that, “President Xi of China is actually making pretty good progress on its structural reform.” Furthermore, Bailey finds the likelihood of successful reform much greater for China than for Europe.

U.S. equity markets have since followed suit, with the Dow Jones Industrial Average recovering from late-August lows, but volatility remains elevated. General consensus believes that recent U.S. market activity, while unpleasant, is a healthy correction and a normal part of the equity market cycle. Still, it can be alarming for those who don’t understand the phenomenon of a correction. Any sustained period of price appreciation, as seen in China as stocks began sky-rocketing in mid-2014, is a warning to many astute investors that a correction may be near. Corrections are necessary when the markets become saturated with investors attempting to take advantage of inflated

asset prices rather than trading on fundamentals. Eventually, the “bubble bursts,” removing speculators from the market and paving the way for a return to a “normal” investment environment.

Turbulent markets following a quiet period of general price appreciation with low interest rates can be troublesome for investors who have become complacent with the current environment. In turn, they may have overextended their portfolio’s risk profile in an attempt to stretch for yield or increase total return. Director of Mutual Fund Research & Marketing Peter Greenberger reminds us that it is in moments like this that Warren Buffett’s investment acumen holds true: “Only when the tide goes out do you discover who’s been swimming naked.”

WHERE ARE WE HEADED?

So what does this say about the future state of the equity markets? Chief Investment Strategist Jeff Saut reiterated his long-term bullish stance, stating, “To a long-term bull, which is what I am, what happened over the last several weeks is just noise. Our belief is that this is a pull-back in an ongoing secular bull market that still has another eight or nine years left to run, providing the averages don’t close below August 25 lows of 15,666 on the Dow and 7,466 on the Dow Transportation Index.”



Managing Director of Equity Portfolio & Technical Strategy Michael Gibbs agreed that this was an ordinary correction, pointing out that it takes time for markets to settle after a significant loss. "During this period, over the next three-six-nine months possibly, the markets have the potential to be more volatile as investors wait and try to get clarity on just what is really happening around the world." He is confident that as time plays out, "Everything will be fine with economic growth. The global economy is still set to grow at 2-3%, as is the U.S. economy, and typically you do not see a bear market in stocks when the economy is growing." Brown concurs, assuring that "despite all of this noise, underlying it all is a domestic outlook from the U.S. which is still very, very promising."

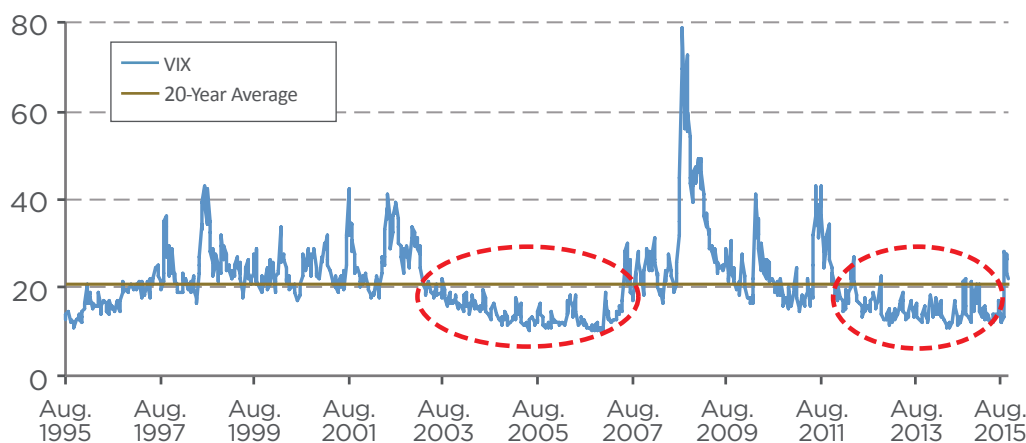
As Gibbs emphasized, "The one thing that investors despise is uncertainty." Given that the short-term market outlook is unclear - as policies unfold in the U.S. and elsewhere - now is an opportune time to re-evaluate current portfolio positioning. In particular, comparing the current risk profile of the portfolio to that of the investor's risk tolerance can identify mismatches that require repositioning. Whether it's paring back or mitigating current risk levels, participating in the glut of buying opportunities available in oversold markets, or simply staying on track;

managing expectations surrounding risk/return objectives is central to reducing investor surprise, panic, and emotional decision-making during volatile market environments. ■

KEY TAKEAWAYS:

- "China's stock market decline is not really indicative of economic weakness, nor is it necessarily going to cause economic weakness. That said, Chinese growth has slowed." - Scott Brown, Ph.D.
- General consensus believes that recent market activity, while unpleasant, is a healthy correction and a normal part of the equity market cycle.
- "During this period, over the next three-six-nine months possibly, the markets have the potential to be more volatile as investors wait and try to get clarity on just what is really happening around the world." - Mike Gibbs
- Given that the short-term market outlook is unclear - as policies unfold in the U.S. and elsewhere - now is an opportune time to re-evaluate current portfolio positioning.

CBOE VOLATILITY INDEX (VIX) Through September 2015



Source: Bloomberg

The CBOE Volatility Index® (VIX)® is based on the S&P 500® Index (SPX), and estimates expected volatility by averaging the weighted prices of SPX puts and calls over a wide range of strike prices.

Should we expect a "Santa Claus" stock market rally in Q4?

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In the hard-nosed world of finance, regular out-performance during the final calendar quarter of the year should not happen, as logic would suggest that such events should be nullified by buying before the final quarter had even started. But the statistics do not lie – and this has been the reality of the average final quarter of the year over the last generation. Traditionally too, September has been a poor performance month, an occurrence which was again apparent this year.

We enter the final quarter of the year with the world's financial markets finely poised. Global growth concerns, the negative impacts of a stronger U.S. dollar and some specific concerns about China's ongoing economic transition negatively impacted markets during the third quarter and suitably crushed investor sentiment around the world. Is it therefore reasonable to expect a strong fourth

quarter of the year performance for global financial markets topped off by a 'Santa Claus' rally into Christmas?

For this to happen financial market participants are going to have to gain comfort with the three areas noted above as sources of market volatility during the last few months. Let's examine each of these areas in turn.

First warning: global growth. During September the Federal Reserve, the European Central Bank and the Bank of Japan all reduced growth hopes for their local/regional economy. The question now is whether the next shift in anticipated growth levels is up or down. Hugely influential for this are the two other factors mentioned: the level of the US dollar and the strength of the local Chinese economy, as both materially impact the world on many levels.

Exchange rates are always important considerations for global investors, as they are the one route by which all the prices in one economy can simultaneously change compared to another one. The strength of the US dollar over the last year has hurt both commodity prices and the emerging markets as well as the

earnings momentum of U.S. multinational corporations. It has also encouraged global imbalances such as an excessively weak Euro and a sharply weaker Yen which has allowed both the

European and Japanese governments to sidestep much needed economic reforms to boost the flexibility and competitiveness of their local economies. Undoubtedly it also played a role in the surprise mini-devaluation of the Chinese Yuan which raised fear levels about how the Chinese economy was performing.

The better news is that some of these fears are starting to permeate decision making and market movements. Helped by the Federal Reserve passing on an interest rate increase in September the U.S. dollar has faded a little and Chinese policy makers appear committed both to their growth targets and economic reform with the aim to expand materially the size of the domestic

consumer segment of the economy.

Even more positive is that investor sentiment levels remain very low. Clearly considerable uncertainties remain but as the adage much repeated by Warren Buffett observes it is better to be

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'greedy when others are fearful'. A U.S. dollar not going up, a Chinese economy buoyed by some new stimulus/reform actions and a communication by company management during the mid-October to mid-November corporate earnings season; business conditions are not completely unworkable. Dividend and share buy backs are continuing and should be enough to push currently uncertain global markets up.

And, of course, make the seasonality indicator correct again. ■

AVERAGE % RETURN OF THE DOW JONES INDUSTRIAL AVERAGE 1961-2011

January	1.2
February	0
March	1.1
April	2
May	-0.1
June	-0.6
July	0.9
August	0.2
September	-0.8
October	0.5
November	1.2
December	1.5

Source: Dow Jones Industrial Average via Yahoo Finance

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