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INVESTMENT STRATEGY QUARTERLY

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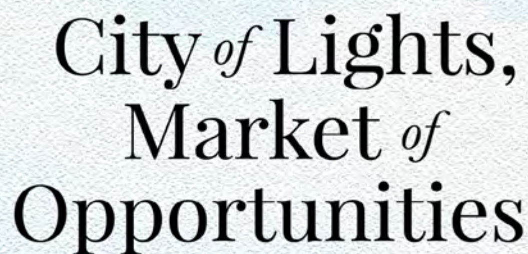

City of Lights, Market of Opportunities

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Letter from the Chief Investment Officer

City Of Lights, Market Of Opportunities

Whilst people from around the world will clearly differ, from the perspective of a US audience there's nothing better than rooting for Team USA! Therefore, we borrow from the upcoming Paris Summer Olympics for our quarterly theme — with a twist. Instead of using the most popular events (like gymnastics, swimming, and track and field) to express our views, we'll go beyond the spotlight. The reason: we advocate looking past the obvious and strive to find value in diverse market areas — because that's how you can add value to a portfolio over time. Just as the market has had its share of surprises recently, the Games will have a few as well. It will be the first opening ceremony not in a stadium, but on boats on the River Seine; the mascot won't be an animal but a hat (the French love fashion!), and each medal will be infused with iron from the Eiffel Tower!

Surfing has only been part of the Olympics since 2020 and will take place 10,000 miles from Paris in Tahiti (an island in French Polynesia). Like a surfer itching to catch a big wave, the extraordinary pent-up demand during COVID amped the US and global economy. But spending is slowing, especially among lower-income consumers as the labour market softens and the impact of inflation takes its toll across developed economies, not just in the United States. The Federal Reserve (Fed) is not the only global central bank to ride the wave of resilient economic activity despite the most aggressive tightening in 40 years, but it is the most notable. Now, however, the Fed's trick is to extend this recovery by cutting interest rates in time to avoid a wipeout (aka recession) without further swelling inflation. There is an opening to keep the surf up if the Fed cuts rates twice by year end and then more next year and it's highly unlikely to be the only central bank aiming to improve conditions.

Just as surfing is far from France, factors beyond the horizons of the consumer and the Fed will impact the US economy. Watch for government spending in an election year and business spending concentrated on artificial intelligence (AI) to offset weakness in consumer spending. Keep an eye on oil prices — which could cause some economic chop if oil goes above our year-end target of $85 a barrel. Overall, we remain optimistic, expecting US GDP growth of 2.1% in 2024 and 2% in 2025.

Beach volleyball requires seamless cooperation between the two teammates. Similarly, the bond markets have twin dynamics, dictated by the economy and inflation. With both set to cool gradually in the remainder of this year, interest rates in the US and elsewhere should keep tipping lower by year-end (10-year Treasury yield target: 4.0%, UK 10-year gilt-edged 3.50%) and the next 12 months (target: 3.75%, UK 3.25%). That will serve bond market returns' modest capital appreciation. Beach volleyball is the newer, trickier version of indoor volleyball — playing in sand, adverse weather (heat, wind, rain), and in front of a raucous crowd. The modern-day bond market has new challenges as well: record government debt issuance, demand unease, and non-traditional Fed central bank policy. Like a beach volleyball team, investors must read and anticipate market moves quickly. For example, cash investments have scored with yields as high as they are, above 5%, but that will likely not last long. So, as the Fed approaches its easing cycle, central bank rate cuts accelerate, transitioning to longer-dated bonds seems prudent. Areas to consider: intermediate-maturity government bonds, including Treasury bonds in the US and high-quality corporate bonds.

Like sport climbing, equities have climbed a wall — a wall of worry about recessions, higher interest rates, elevated valuations, and geopolitics. Thus far, the path higher has been relatively uninterrupted, as the S&P 500 in particular, has had only one 5%+ slip this year and only one 10% tumble since the bull market started 21 months ago. In sport climbing, the courses get progressively more difficult. The quest for the market to move higher is getting more challenging, especially with valuations at their highest level since January 2022. In the near term, it may be harder for equities to find a handhold if volatility increases because of growing economic, earnings and election uncertainty. Still, in the longer term, the equity market rally is likely nowhere near the top. It should get support from Fed central bank policy easing, lower interest rates, and some of the ~$6 trillion money parked in money market mutual cash funds transitioning into the equity markets. And remember, historically, the average bull market lasts over five years, so it should continue climbing! Our year-end and 12-month targets for the S&P 500 are 5,400 and 5,700 respectively, whilst the UK index is forecast to reach 9,000. While the US tech sector has dominated, market performance should broaden as smaller company earnings accelerate. Across

market capitalisations, we prefer the Technology, Industrials, Energy, and Health Care sectors.

Breakdancing, or breaking, will be in the 2024 Summer Olympics for the first time! Like breakdancing, AI used to be more 'underground' (I was breaking in the 80s!), but it has now emerged onto the brightly lit stage. Since computing capabilities have only recently supported advanced AI at scale, we are in the early stages of this cycle. AI-driven earnings growth should remain robust for semiconductors and cloud computing as well as software and hardware. AI's challenge is a throwdown to 'business as usual'. It's likely to continue to receive a standing ovation in the financial markets.

Speaking of ovations, the exploding popularity of women's basketball demonstrates that the US has the infrastructure to develop many of the world's most skilled and talented players. The team has been dominant, with no Olympic losses since 1992. It holds the record for the most consecutive team victories in all Olympic sports. The US equity market has similarly jumped above the global competition, outperforming developed market equities for eight of the last ten years by a cumulative 170%!

The reasons are familiar: the US has the strongest economy (infrastructure) and the most fundamentally sound and profitable companies. The Dream Team of tech-related companies should earn the US another gold medal. This isn't a slam dunk, as the difference between the US and the rest of the world on both the court and in the equity market has narrowed. Both teams will have to play their best to win. The biggest competitors to US equity dominance are: first, Japan, where strong corporate governance, domestic inflows, and a strengthening yen could bolster performance; and second, emerging markets, where attractive valuations, healthy earnings growth, and easing central bank policy should help.

In politics, President Biden and former President Trump have already begun wrestling — one of the oldest sports in the Olympics. The candidates are locked in and trying to score a takedown. The US election outcome in November could dramatically impact trade, immigration, tax policy and industry regulation. As a result, expect increased market volatility over the summer and early autumn. While polls show neither candidate in danger of being pinned yet, the match will most likely be determined in the six major swing states. Our base case is that the House and Senate shift power and result in a divided government. But we caution that the market is underestimating sweep scenarios that could lead to more significant policy shifts.

Asset allocation is more important than ever to investors' portfolios. It's like artistic synchronised swimming — above water, it is beautifully choreographed, but underwater, team members must do their part under pressure, using incredible strength and attention to detail — while holding their breath. That's our goal — to provide a well-designed asset allocation strategy without burdening you with all the complicated analysis our top athlete analysts do behind the scenes. Our goal is aligned with yours: podium-worthy performance for you. A skilled coach — your wealth manager — can help keep you in sound financial shape in both good times (like recently) and challenging times. But as gold medal-winning gymnast Simone Biles said, "The hardest days are best because that's when champions are made".

See you on the medal podium!

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

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US Election 2024: Prepare For A Sweep?

Ed Mills, *Washington Policy Analyst, Equity Research*

With most of the focus of the 2024 elections on the rematch between President Biden and former President Trump, the race for Congress can easily get overlooked. Our analysis for the Senate shows a solid advantage for Republicans to win a majority of seats. In the House of Representatives, it is a closer call, but several factors have Democrats as the slight favourite for the majority. With divergent House and Senate calls, it is easy to assume that divided government is the most likely outcome, but we come to a different conclusion. In our view, if Democrats beat the odds and retain a Senate majority, that likely comes with a Biden re-election and a House majority. Conversely, if Republicans maintain a House majority, the chances of a Trump victory and Republican Senate majority also increase. As such, the combined odds of either a Republican or Democratic sweep should be considered. In a sweep, the ability to advance major policies on a party-line vote increases—important for the return of the debt limit in January 2025 and the expiration of the 2017 individual tax cuts on December 31, 2025.

ELECTORAL BACKGROUND: SWING STATES AND ‘DOUBLE HATERS’

In assessing the presidential race there are multiple factors we actively track, including: which states are critical for each candidate as they seek 270 electoral college votes; the favourability of each candidate; and general sentiment of the country—such as recession indicators and polling data on whether voters view the country as “on the right or wrong track”. At this time, both President Biden and former President Trump have more voters who have an unfavourable opinion than a favourable opinion, making it necessary for the winning candidate to convince some portion of voters to vote for him, despite having a negative opinion of his candidacy. The group of voters who have an unfavourable opinion of both candidates are referred to in the polling industry as ‘double haters.’ In 2016 Trump won a majority of this group and the presidency. In 2020, Biden won the majority of this group and the presidency. The winner of this group in 2024 is likely to be the winner of the presidency.

THE SIGNIFICANCE OF CONGRESS

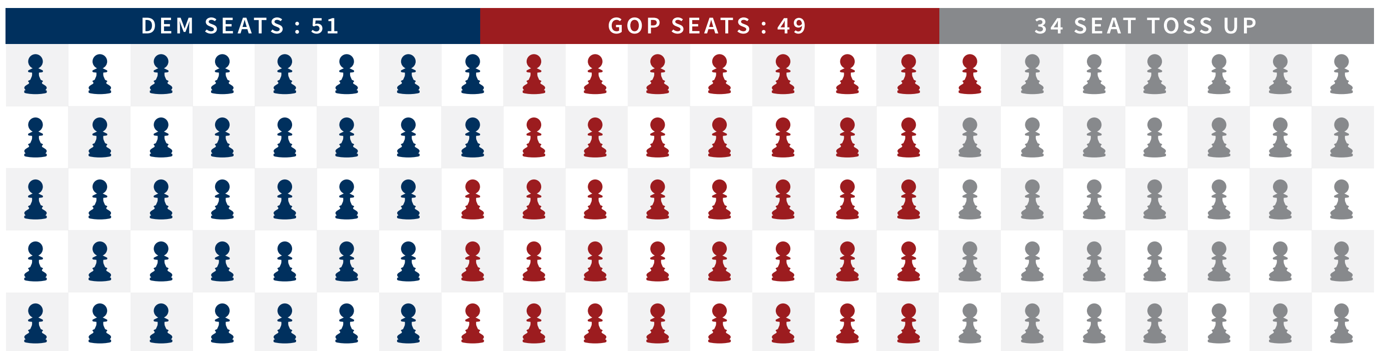
The largest policy changes in DC come when one party has full control of the House, Senate, and the White House. In recent years, Congress has been using the budget reconciliation process to enact sweeping legislation, including tax cuts, the Inflation Reduction Act, COVID relief, and major portions of the Affordable Care Act.

In 2025, we have a series of fiscal cliffs that Congress must address: notably, the debt limit and the expiration of the individual portions of the 2017 Trump-era tax cuts. The winner of the presidency will largely dictate the terms of these debates, but the ability to enact sweeping changes would be unlocked if either party has full control.

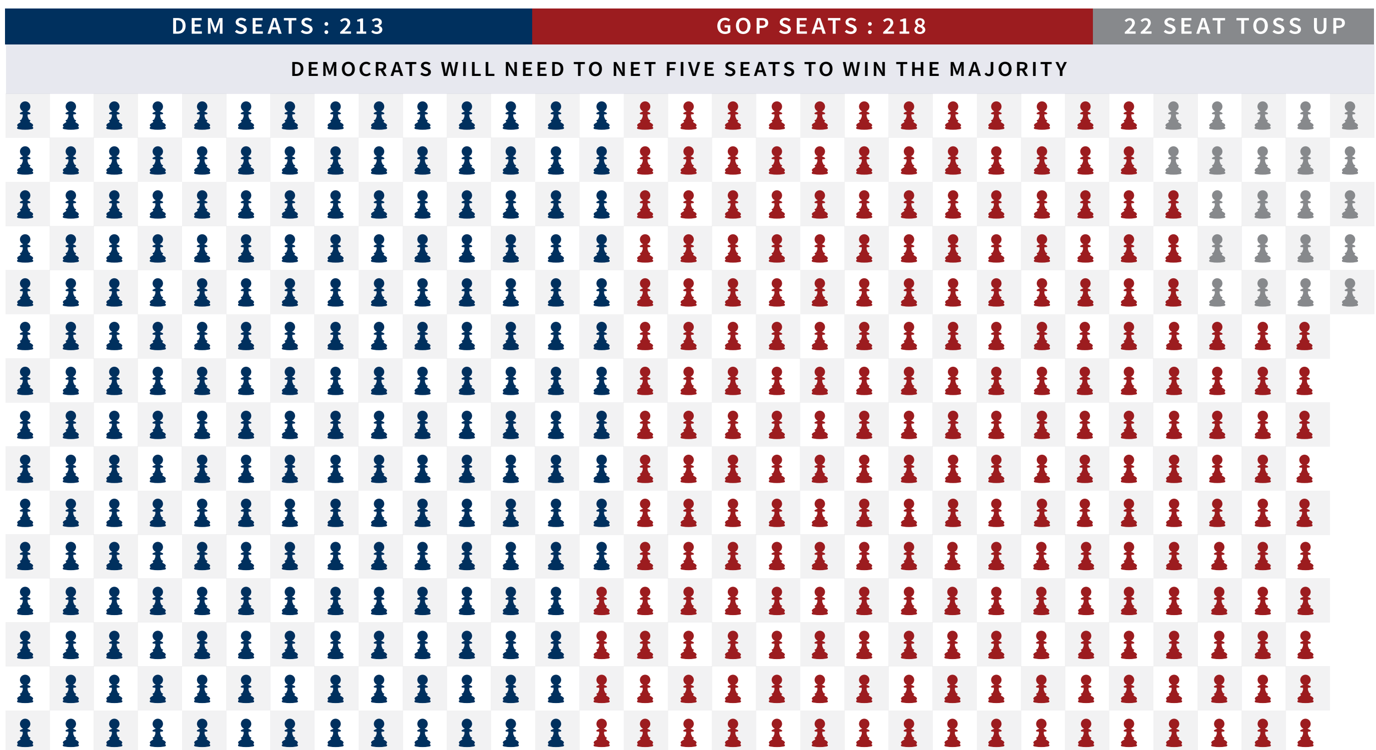
CONGRESSIONAL FACTORS SUPPORT OUR VIEW OF A SWEEP

In the House, where all 435 seats are on the ballot, Republicans currently have a 218-213 majority. Democrats will need to net five seats to win the majority and they should get some assistance with several states adjusting their congressional districts. The fights over the Speaker of the House have also slowed some Republican fundraising efforts compared to past election cycles, adding to the Democrats' edge. However, with only 22 seats currently rated as toss-up and recent elections swinging the House toward the winner of the presidential election, a majority by either party remains a possibility.

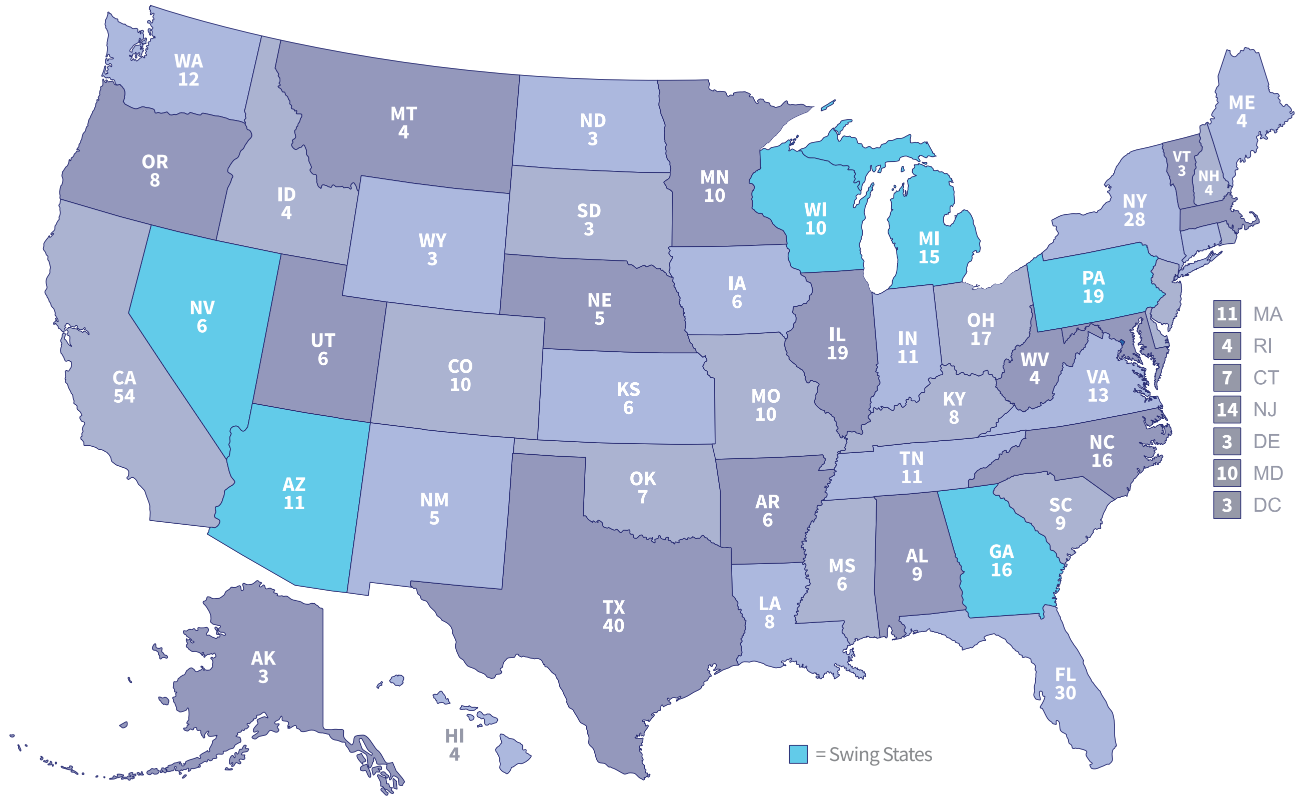
SENATE SEATS



HOUSE SEATS



Electoral College Votes By State



As for the swing states, this is an election that will likely come down to the winner of a majority in each of Arizona, Georgia, Pennsylvania, Michigan, Nevada and Wisconsin. Underscoring the importance of these states, a swing of 45,000 in 2020 in AZ, WI, and GA would have resulted in a 269-269 tie. All indications point to a close contest again in 2024 in these states, but a number of known factors (i.e. debates, Vice President selection) and unknown factors (i.e. geopolitical events) between now and November could sway this election in either direction.

In the Senate, Democrats currently have a 51-49 seat majority, but are likely already down to a 50-50 tie when one factors in the upcoming retirement of Senator Joe Manchin (D-WV). In the Senate, one-third of the 100 seats are on the ballot every two years. This year, of the 34 seats on the ballot, 23 are currently held by Democrats and 11 by Republicans. The imbalance of seats comes from a strong performance by the Democrats six years ago in the 2018 midterm elections. Democrats are even more on the defensive in the Senate when you factor in the decline of ticket-splitting (when a voter votes for candidates from different political parties) in recent years. Top Republican targets are the Democratic senators in Montana and Ohio, two states expected to vote for Trump in November. Despite a strong playing field for Republicans, we have also seen unexpected events in recent Senate elections, and it is not out of the question that Democrats are able to "run the table" (decisively accomplish a desired outcome) and preserve a 50-50 tie. In a tie scenario, the Vice President is the tie-breaking vote.

> The ability to enact sweeping changes would be unlocked if either party has full control.

RETURN OF THE DEBT LIMIT: WHAT TO WATCH

The debt limit will be an immediate concern for the next president, with it returning in January 2025 just as either Mr Trump or Mr Biden is inaugurated for a second term. At midnight on 1 January 2025, the federal government will begin to deploy 'extraordinary measures' to stave off a default; using the 2023 debt limit as a

guide, we expect that the 'X-date' (the date when the federal government is no longer able to meet its debt obligations) will fall during midyear. With a $35 trillion national debt and an almost $2 trillion annual federal budget deficit, and more than a $1 trillion annual debt service burden, lifting the debt limit has both political and market implications.

The return of the debt limit will raise the risk of brinkmanship, with negative impacts for volatility and broader market sentiment. A split government scenario would likely exacerbate these risks, as well as placing pressure on both parties to accept serious policy concessions to avert a default — especially if current concerns around the US fiscal trajectory continue to intensify. These concessions could include repeals to parts of the 2022 Inflation Reduction Act; while we do not expect the law to be fully repealed (even under a GOP sweep), certain provisions (such as the electric vehicle (EV) tax credit) could be targeted to offset the cost of new debt issuance. The debt limit is extremely likely to be lifted, but we could see the creation of a new effort to rein in the debt and deficit (with actual cuts unlikely in the near term).

WILL THE 2017 INDIVIDUAL TAX CUTS BE EXTENDED?

The second key fiscal cliff to watch will be the expiration of the individual provisions of the 2017 Tax Cuts and Jobs Act (TCJA) on 31 December 2025. We would expect the winner of the White House to dictate much of the 2025 tax debate—particularly under a sweep scenario in either direction, which would unlock the ability to use reconciliation to pass a bill with a simple majority.

A key factor to watch in the tax debate will be what Congress wants to pass versus any potential market volatility that could limit congressional action. A complicating factor for the extension of the 2017 tax bill is the growing price tag, which is now estimated at $4.6 trillion to extend for ten years. The growing cost of extension could reopen the debate regarding the corporate tax rate of 21%. The corporate tax rate was made 'permanent' in 2017, but members in both parties are discussing the potential need to increase this rate as a way to pay for the extension of the expiring individual provisions of the 2017 law.

The return of the debt limit will raise the risk of brinkmanship, with negative impacts for volatility and broader market sentiment.

In a Democratic sweep scenario, there will be pressure to let the 2017 changes expire, as taxes would revert to the tax code under President Obama, including removing the $10,000 limit on state and local tax (SALT) deductions. The removal of the limit on SALT deductions would be a tax cut for many taxpayers in states with higher taxes, including many states represented by Democrats in the House and Senate. We ultimately view Democrats as likely to preserve lower income tax brackets for those earning less than $400,000, but allow higher taxes on individuals above that income level, as well as making changes to capital gains taxes to offset the cost.

In a Republican sweep scenario, House Speaker Mike Johnson (R-LA) has previewed a swift passage of a reconciliation bill that could include additional individual tax cuts, pairing the bill with an increase in the debt limit, but also new immigration provisions. This was also a strategy after the 2016 election, but DC was not prepared for a potential Trump victory. While there is more preparation for a potential win in 2024, the potential negative reaction to increased government debt by the bond market becomes a new variable.

KEY TAKEAWAYS:

- Don't assume a divided Congress will be the outcome.
- At this time, both President Biden and former President Trump have more voters who have an unfavourable opinion than a favourable opinion. Winning over these 'double haters' will be necessary for victory.
- Eyes will be on the swing states of Arizona, Georgia, Pennsylvania, Michigan, Nevada and Wisconsin.
- 2025 brings twin fiscal cliffs: the debt limit debate and the expiration of the individual portion of the 2017 Trump-era tax cuts.
- The return of the debt limit will raise the risk of brinkmanship, with negative impacts for volatility and broader market sentiment.

Anxiety In The Euro Area As Political Risk Returns

Professor Jeremy Batstone-Carr, *European Strategist*

> "The age of abundance is over" – French President M. Emmanuel Macron

Financial markets are discounting mechanisms. That is to say that they take the sum-total of all knowledge and attempt to project what is known into the future. Generally, this works pretty well when applied to economics and other factors germane to financial asset performance. But what markets typically struggle to price effectively are political outcomes, particularly when those outcomes are themselves mired in uncertainty. Imagine then, the shock delivered by French President M. Emmanuel Macron's surprise decision on 9 June, prior even to the final results of EU parliamentary elections, to dissolve his country's lower house National Assembly and hold snap elections over, as is usual, two consecutive weekends on 30 June and 7 July. M. Macron's move may have been prompted by his political grouping's poor showing in EU elections, but it bears all the hallmarks of far greater domestic considerations. The response in the financial markets was immediate, the differential between the yield of French government bonds and their more stable German counterpart spiked higher while the French stock market fell sharply. But while France is clearly the epicentre of reawakened political risk, what chance is there that the contagion might spread?

WHAT IS IT THE EU FEARS?

In Nick Roeg's film Don't Look Now, the Italian police inspector regards the leading actor (played by the sadly recently deceased Donald Sutherland) with a gimlet eye and asks quietly, but pointedly, "What is it that you fear?". For the European establishment, inheritors of what, even after more than two decades, remains a work in progress, the challenge lies in how to address the evolution of new and politically more extreme political parties springing up across the continent without fracturing, perhaps terminally, the ongoing project. M. Macron's unpopularity

with voters on both sides of the political divide in France threatens just such a destabilising outcome. Whilst financial markets struggle effectively to price political outcomes, they respond even less favourably to potential instability. So, whilst the EU parliamentary elections delivered a strengthening in the centrist bloc from which Commission President Ms Ursula von der Leyen (whose nomination for a second term must be ratified by the incoming legislature) derives her support, populism antagonistic to the status quo is on the rise, be it in Italy, Hungary, Poland, the Netherlands, France and even Germany where the Alternative for Deutschland Party continues to make headway ahead of national elections next year.

WHAT ARE THE ISSUES?

The focal point for the disaffected is, as is so often the case, immigration. Large numbers of both legal and illegal immigrants crossing regional and national borders have created tension and pressure on public services, a tension most notably illustrated by the collapse of the Netherlands government in the autumn of last year. But whilst immigration may serve as the lightening rod, behind it lies deeper macroeconomic issues associated with sclerotic economic activity that persistently bedevils the Euro Area and even more pertinently, a high cost of living which, while easing, is doing so only very slowly against a backdrop of still high interest rates, both in nominal and inflation-adjusted terms even despite the European Central Bank's recent decision to embark on a small downward adjustment.

But for Brussels and Strasbourg a deeper concern lurks. Policies enacted during the pandemic may have been aimed, firstly, at softening the blow to both households and businesses caused by lengthy lockdowns and immediately thereafter to offset the adverse impact of an energy crisis. But with the direct consequence of sanctions imposed on Russia following its invasion of Ukraine, the result has proved to be a spiralling deterioration in the public finances of many but the most hair-shirted of regional members. These immediate crises having passed, the European Union's supra-national bodies are now seeking both to regulate and thereafter reduce the public debt and deficits of member states back towards, if not immediately to, levels more commensurate with overhauled fiscal rules deemed an essential part of belonging to the single currency zone.

Behind this compulsion lies a key pillar around which the Euro Area was originally created; that in order to participate in the project, individual states must accept that, firstly, their public finances are a matter of concern to all members and that to enjoy the benefits bestowed by a common short-term interest rate set by the Central Bank, a disciplined approach to fiscal policy is a prerequisite. Secondly, member states must participate in EU-inspired initiatives such as the climate agenda and defence, neither of which come cost-free.

What European institutions want is for national governments to behave responsibly, and behind them their populations, voters, to behave as good Europeans and act not in self-interest but for the greater good of the region more generally. Whilst a worthy aspiration, the reality is that populations typically put domestic considerations foremost during periods of economic hardship and it is this realisation that has resulted in populist political parties pursuing agendas antipathetical to wider goals, encouraging financial markets to drive longer-term interest rates higher.

In partial recognition of this fact, the European Union has rowed back on its demands, no longer requiring deeply indebted states to bring debt-to-GDP ratios down to the 60% level envisaged by pre-existing treaty immediately, but to do so over time. This lesser objective, merely encouraging fiscal policy discipline rather than enforcing policy which would result in immediate economic depression and by extension the far greater threat of regional fragmentation, comes with guidelines as to how spending and taxation might be applied. This relaxation has already borne fruit; the hitherto avowedly anti-European 'Roman firebrand', Ms Georgia Meloni, leader of the Italian Brotherhood alliance and Italy's first female prime minister, has overseen an adjustment in the country's fiscal policy objectives to the extent that whilst still loose they do at least fall within pre-existing 'golden rules'. In consequence it is thought possible that her administration might survive a full term in office, remarkably the first time that has happened in Italy since WW2.

FRENCH POLITICS: LET THE PEOPLE DECIDE

Unlike his neighbour to the south, M. Macron has failed to deliver on the EU's fiscal requirements. Whilst successfully raising the French pension age from 62 to 64, this has come at a huge cost in terms of his personal popularity and that of his centrist political vehicle, La Republique En Marche (LREM). In an effort to improve France's competitiveness, the already minority LREM administration has successfully lowered social security charges and company tax rates aimed at reducing business costs, but the country remains

mired in bureaucratic red tape which has enraged powerful and deeply reactionary unions whilst simultaneously forcing a rebellious population onto the streets in protest.

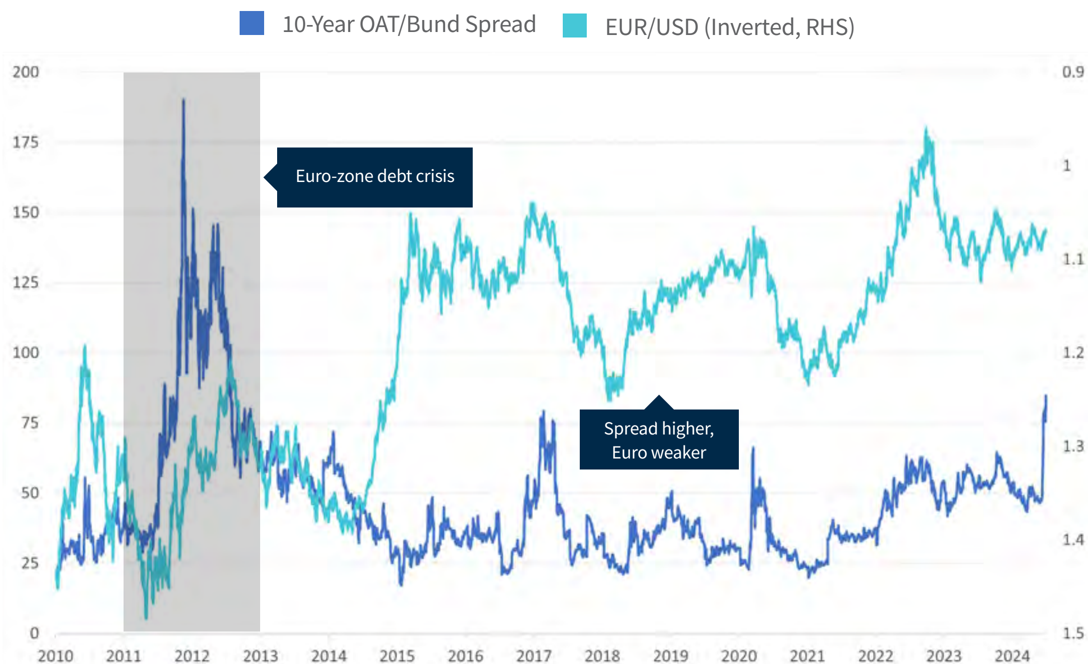
It is this sense of frustration that has encouraged the continuing rise of the French political right (National Rally, NR) led by Mme Marine Le Pen and M. Jordan Bardella and a resurgent political left, now united as the New Popular Front (NFP: Nouveau Front Populaire). These groupings want power and have seized on the opportunity seemingly gifted upon them by the decision to dissolve parliament. Prior to the vote, public opinion polls had the National Rally at 36%, the NFP on 30% and LREM on 20.5%. If accurate (and despite the National Rally's strong showing in the first-round Assembly elections, final figures are very much open to question given the significance of tactical voting and turnout in French elections), this would translate to between 220-260 seats, 185-215 seats and 70-100 seats respectively in an Assembly where 289 seats is the threshold for majority control.

In order to curry favour (and financing), the National Rally has moderated its position on a number of key issues without, apparently, alienating its traditional support base. However, and despite M. Bardella's protestations to the contrary, financial market pricing reflects persistent anxiety that, if in office, pre-election commitments might not be honoured. That the French business community is reportedly rallying around the right reflects concern regarding the even more populist agenda of the left, included within which lies a commitment to lower the retirement age to 60, provide assistance to migrants and asylum-seekers, freeze prices of essential goods and energy, push up civil service pay and increase the minimum wage by 15%. The plan is to pay for this with sharply increased taxes on wealth, property and inheritance. Whatever the European institutions' and financial markets' residual fears regarding the French right might be, they are as nothing compared to those associated with the political left.

IMPACT

The most obvious threat, both to the goals of the European institutions and financial market stability, therefore lies in a potential French Assembly majority for either the political right or the left, and consequent repudiation of the EU's fiscal rules in favour of a more populist agenda. However, the hope lies in perhaps the most likely scenario, at least judging by opinion polling, that no party is able to form a majority and a fragmented parliament achieves a cobbled-together coalition in which M. Macron's gamble, the centrist LREM bloc, holds the balance of power. In such a scenario, whilst the French debt/GDP ratio of 112% and general government deficit (the shortfall between government revenue and spending) at 5.5% remain high by the desired standards of the region's now implemented 'Excessive Deficit Procedures', a slow-paced return to more acceptable levels is possible.

In such circumstances, the risk premium now apparent in the French stock market would likely remain high, but perhaps no higher than would likely be the case should a more extreme electoral outcome occur. More importantly, the threat of possible contagion into the financial assets of other countries also deemed in breach of fiscal rules would be less likely. The obvious vulnerability lies in the fact that a loose-knit coalition of widely



Source: Bloomberg

varying philosophical beliefs could break down at any time and a vote of no confidence bring down the fragile administration. The French Constitution precludes M. Macron from dissolving the Assembly for another year (July 2025) and in the event of complete policy paralysis this could put his own position as president at risk.

Pricing in the financial derivatives market confirms that investors have become significantly more worried about potential 'tail risk' outcomes (those differing from the best-case scenario). The relationship between the relative pricing of instruments relating to both the euro and the US dollar reflects the non-negligible chance of a destabilising outcome. The Euro Area's history of periodic crisis reveals a close correlation between bond market pricing and the performance of the common currency. Unsurprisingly, during periods of elevated political risk the euro typically weakens against key pairs, including both sterling and the US dollar. Although the UK election has inevitably dominated domestic media headlines, the outcome has long been thought to be in little doubt and given only comparatively small differences in projected policy between the leading parties, investors in financial markets have long regarded the UK as a haven of stability over its neighbour. This was recently exemplified by a 10-year benchmark gilt-edged auction which hauled in a record amount of funding for the Treasury.

CONCLUSION – DO ELECTIONS MATTER?

For all the heat that elections generate, the truth is that they seldom make a lot of difference to economic performance over the long-term. In response to the question, do elections matter, their significance from the perspective of the financial markets lies in the potential impact outcomes might have on the always delicate relationship between the bond market and the government. Mr James Carville, political advisor to the administration of President Bill Clinton, once famously noted that if he believed in reincarnation he'd want to come back as the bond market, "That way you can intimidate everybody!"

Expansionary fiscal policies have proved supportive to developed economies during and after the pandemic and in response to higher interest rates. But maintaining fiscal discipline against the backdrop of a heavy debt burden is essentially a game of confidence. If investors believe that a government is capable of pursuing fiscally responsible policies, they will typically try to see past temporary increases in both debt and deficits. But if that confidence is lost, then markets respond immediately, driving asset prices lower and yields sharply higher, increasing borrowing costs and making a country's fiscal position less sustainable.

This is essentially what is happening in the Euro Area, and more specifically in France. France's importance lies in the fact that not only is it the Euro Area's second largest economy, but that it boasts the world's fourth largest bond market. Instability here risks spilling over elsewhere, a fact not lost on the European Central Bank which has expanded its 'tool kit' to stand in support were disorderly conditions to evolve. It is this ultimate backstop that should encourage investors to keep faith in European financial assets over what could be a testing period in the months to come.

KEY TAKEAWAYS:

- The re-emergence of Euro Area political risk has adversely impacted investor sentiment towards the region's financial assets and raised the threat of 'tail risk' outcomes.
- The epicentre of this elevated anxiety is France, the region's second largest economy and the world's fourth largest bond market.Without a significant uptick in births, the United States and other developed economies will have to increase their immigration levels to meet the need for workers.
- President Macron's decision to hold snap lower house elections has raised the possibility that an incoming administration, dominated either by the political right or left, could pursue policies repudiating the EU's fiscal rules.
- The two-phase French Assembly election outcome is notoriously hard to predict given the prevalence of tactical voting and an uncertain turnout.
- The EU has introduced 'Excessive Deficit Procedures' against France and four other member states, including Italy, requiring the pursuit of fiscally responsible economic policy.
- The European Central Bank has cut key regional interest rates but may need to go further were financial market pricing to become disorderly.

Beyond Demographics

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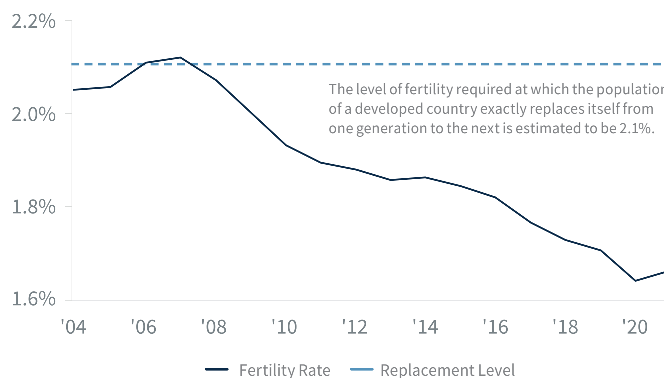
The global population has surpassed 8 billion and according to the United Nations, it is projected to reach 9.7 billion in 2050.[1] However, its growth trajectory reached the lowest level ever recorded in 2022 and is expected to continue to decline. Seems counterintuitive, no? Under the current demographic trajectory, the global population will likely follow a sustained decline for the first time in recorded history starting toward the end of the century.

Two factors are reinforcing this trend. Global life expectancy continues to increase and is expected to reach 77.2 years by 2050.[2] This is an almost a five-year increase compared to today's life expectancy, almost ten years higher compared to 1950, and more than thirty years higher compared to 1900. Second, the level of fertility at which a population replaces itself from one generation to the next, sometimes known as a country's population replacement levels or total fertility rate (TFR), has been declining steadily for decades. The current world's TFR is ~2.3 but estimates suggest that the rate will fall below 2.1 around 2050. By 2100, 183 out of 195 countries will have fertility rates below population replacement levels.[3]

With improvements in public health, better living conditions, and overall environmental improvements, it is relatively easy to understand why human life expectancy has increased over the years. Additionally, the number of people living below the poverty line has declined over the last three decades from over 2 billion people to 700 million.[4] Fewer people will go undernourished and without access to safe drinking water. These trends are expected to continue, improving the quality of life among developing economies while increasing longevity.

US Fertility Rate Below Replacement Level



Source: FRED, data as of 12/31/2022

[1,2] https://www.un.org/en/global-issues/population
[3] https://www.healthdata.org/news-events/newsroom/news-releases/lancet-world-population-likely-shrink-after-mid-century
[4] https://www.worldbank.org/en/topic/poverty

Improvements in global quality of life may be contributing to declining fertility rates, especially in developed economies. Many working-class families, especially in rural areas, had numerous children for several reasons. First, children could be considered relatively cheap labour and help around the farm; second, higher child mortality rates meant having more children would increase the probability that the children would look after parents in old age. Fast forward to today and developed economies no longer need to rely on child labour due to improvements in technology; child mortality rates have declined considerably; and contraception is more available. Moreover, especially in developed economies, the cost of having a child has increased exponentially and families have continued to delay having children.

THE WEST IS GETTING OLD

"So, who's going to fund programs like Social Security if the population is declining?" you may be wondering. Let's look at the numbers: in the field of demography, a country's population dynamic can be illustrated by the distribution of age group and gender. When the population is growing, this distribution is shaped as a pyramid, with more younger people at the bottom, and fewer older people at the top. The charts below illustrate what the United States population looked like in 1900, when the population was growing rapidly and how it looked in 2020.

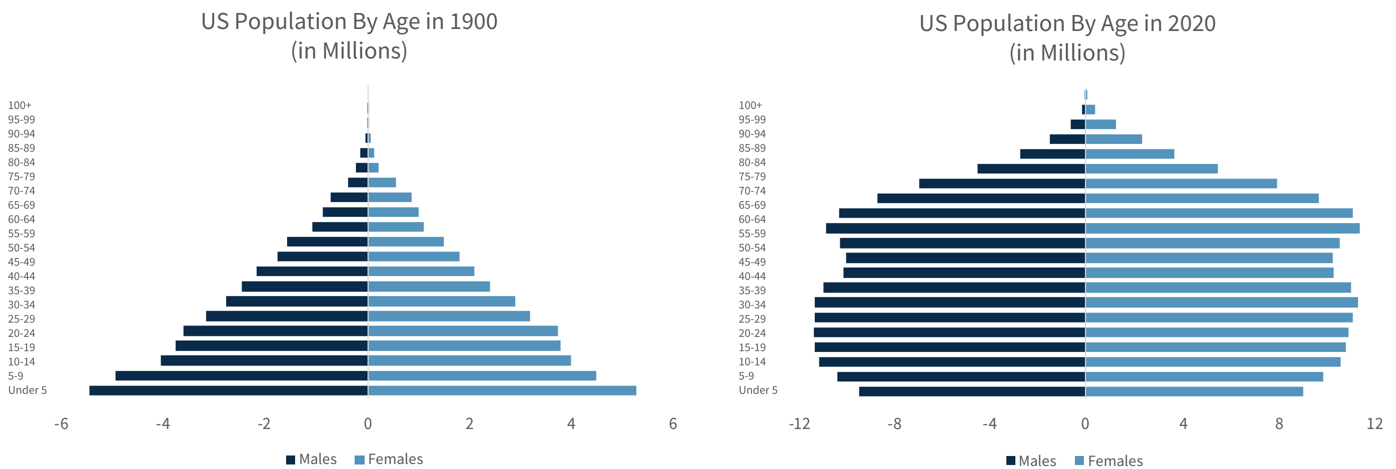
Over time, the fertility rate in the US declined, the median age increased from ~23 to ~39 years old, and the pyramid started to widen in the middle-aged groups. As this trend persists over time, fewer younger people will mean fewer people giving birth. The bottom line is that over time, with the combination of higher life expectancy and lower births, the US population will likely continue to grow older, running into the risk of having an inverted population pyramid in the future.

Of course, the US is far from alone in this respect. Indeed, part of the problem faced by the Euro Area and forming part of the region's re-emergent risk profile is that in addition to already stretched public finances (well in excess of levels envisaged at inception), exacerbated by the pandemic and subsequent energy crisis in 2022, a significant demographic challenge is emerging to the extent that the average remaining life expectancy after the age of 65 has increased over the past two decades alone from 17.8 years to 19.5 years in 2022. Not only does this put pressure on existing resources, unfunded benefits, including pension payments, will add an additional financial burden for future generations.

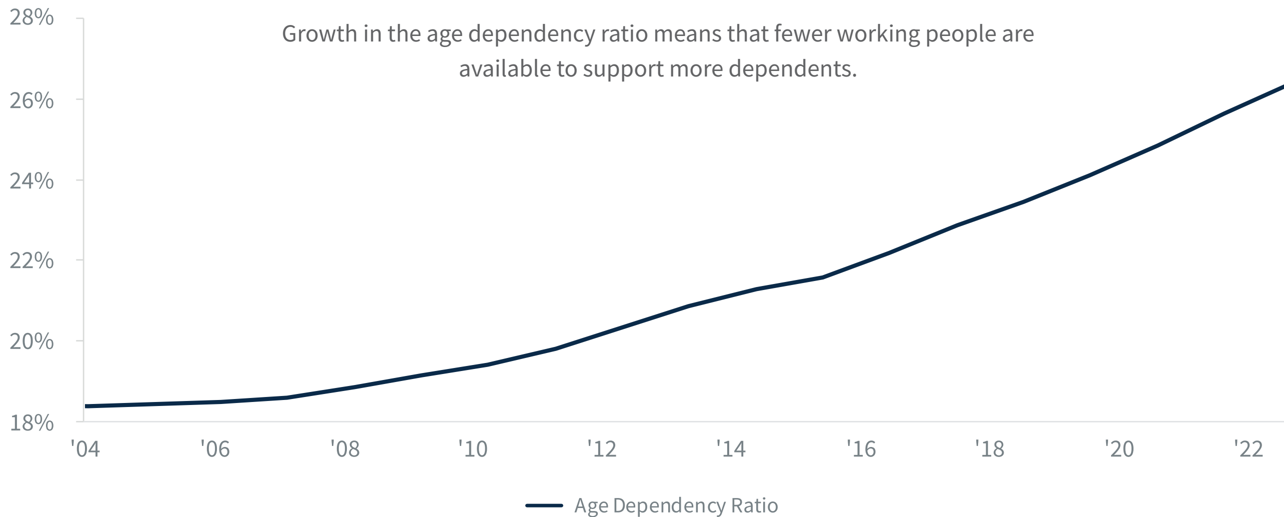
The US's TFR has been in a narrow range of 1.7 to 2.1 births per woman since the 1970s, and it's been below the replacement level for most of this period. However, during the same period, the US population has increased by roughly 120 million, with approximately half of that surge attributed to net migration. In fact, if it wasn't for immigration, the US would have likely already joined (or be close to joining) the likes of Japan, Italy, Greece and Portugal in having a shrinking population.

Demographic Shift

The two charts depict the transformation of the US population pyramid from a traditional triangle shape to a stationary pyramid with more equal proportion in each age group.



Source: US Census Bureau, data as of 12/31/2020



Source: RJ Economics, data as of 6/30/2024

An inverted population pyramid is not good news when it comes to demographics and economics. This is because the age dependency ratio, which measures the dependent population (between the ages of 0 and 14, and older than 65), divided by the population typically in the labour force (between the ages of 16 and 64), increases. Growth in the age dependency ratio means that fewer working people will be available to support more dependents. For example, in the United States in the 1950s, more than six people supported each dependent, while today there are fewer than four people for each dependent, meaning fewer working-age people carry a larger burden.

A smaller working-age population contributes to shortages of workers and lower production capacity, which ends up hurting economic growth. Similarly, fewer workers means a tighter labour market, which can ultimately lead to higher labour costs as well as upward pressure on prices, i.e. higher inflation. Fewer workers also means lower tax revenues, which could deal additional blows to the already unsustainable pension commitments of governments. This could put even more pressure on the ability of the US government to support government programmes, on fiscal deficits as well as debt levels over time. If these problems are not faced head-on, developed countries may be forced to issue more debt to support their respective aging populations over time, which combined with large issuance of debt to fight economic crises, only adds to already large national debts long term.

In the United States, Social Security, Medicare, Medicaid, the Children's Health Insurance Programme (CHIP) and marketplace subsidies spending account for 10.7% of GDP; but according to Congressional Budget Office (CBO) projections, these expenses will account for 14.3% of GDP by 2050. On the other hand, as the working-age population continues to decline, tax revenues are expected to only increase by $1 trillion per year between now and 2050.[5] While these projections are developed under current law, therefore assuming no changes in tax revenues and/or expenses, the increase in the aging population will continue to have an impact on the US budget.

IMMIGRATION PARADOX

Without a significant uptick in births, the United States will have to maintain, and soon increase, its net migration levels. Enhancements in productivity and the evolution of artificial intelligence (AI) offer hopes of alleviating the situation, but the country will still need more people to meet the growing needs of an ageing population. Thankfully, the US is still considered by many as the land of opportunity, confirmed by the 10.4 million non-immigrant visa approvals and nearly 500,000 immigrant visa approvals issued in 2023.[6] The large number of immigrants to the US over the last few

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[5] https://www.cbo.gov/system/files/2024-02/59710-Outlook-2024.pdf
[6] https://www.boundless.com/blog/state-department-visa-report/

> Current immigration policies are unlikely to be adequate to meet the needs of the US economy.

years has increased the supply of available workers, allowing the country to add a record number of jobs without putting excessive pressure on wages, and ultimately additional unwanted pressures on inflation. However, despite this large number of immigrants, the US still has ~8.5 million job openings that are going unfilled as employers struggle to find workers.

When it comes to immigration, US economic policies have not been updated since Ronald Reagan signed the Immigration Reform and Control Act in 1986, which requires employers to confirm employees' immigration status before hiring them. However, this policy hasn't been revised in over three decades (minor changes were implemented in 1990) and the annual immigration caps of the various visas are unlikely to be adequate for the needs of the US economy. For reference, real GDP in the US was $8.9 trillion in 1990 and it's now ~$23 trillion. The economic benefits of immigration reform would expand beyond addressing demographic shortfalls, but it could, for example, boost reshoring efforts as employers would be able to hire more skilled workers. Furthermore, proper immigration reform could reduce illegal immigration by providing additional pathways to those currently trying to come in illegally.

An increase in immigration typically addresses labour shortages in affluent nations like the US and other developed economies, while simultaneously alleviating issues with job scarcity in developing economies. Therefore, proper immigration reform alone could provide some relief to the declining demographics of the US economy and developed economies more generally, but it is unclear when or if the immigration quotas will be increased. However, the combination of additional labour and an increase in productivity could be the catalyst for future economic growth.

KEY TAKEAWAYS:

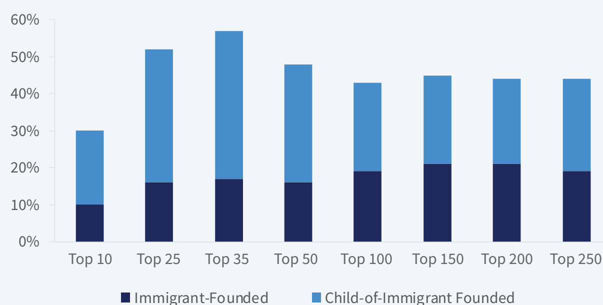
- The global population is heading into a sustained decline for the first time in recorded history.
- A shrinking US working-age population means fewer people to contribute to programs like Social Security.
- Without a significant uptick in births, the United States and other developed economies will have to increase their immigration levels to meet the need for workers.
- Reform is needed to support the US economy in particular and to reduce illegal immigration.

IMMIGRANT CONTRIBUTIONS

Immigrants in the US account for ~13.6% of the US population and 78% of them are of working age. Just like native-born residents, immigrants use public services like education, healthcare and public safety, but according to the American Immigration Council, "immigrants' economic contributions far outweigh the cost of additional public services they incur". This segment of the population contributes over $500 billion a year in taxes, and it is estimated to have a spending power of approximately $1.4 trillion. Immigrant workers fill critical labour shortages in agriculture, hospitality, healthcare and service jobs, and also in highly competitive STEM industries (science, technology, engineering, mathematics).

Immigrants have historically supported job creation in the US, with 45% of Fortune 500 companies founded by immigrants and/or children of immigrants, according to a study published by Brookings.[1] Similarly, according to the National Foundation for American Policy,[2] 65% of the top AI companies in the US are founded or co-founded by immigrants, while 70% of full-time graduate students in AI-related studies are international students.

The Diversity of Fortune 500 Founders



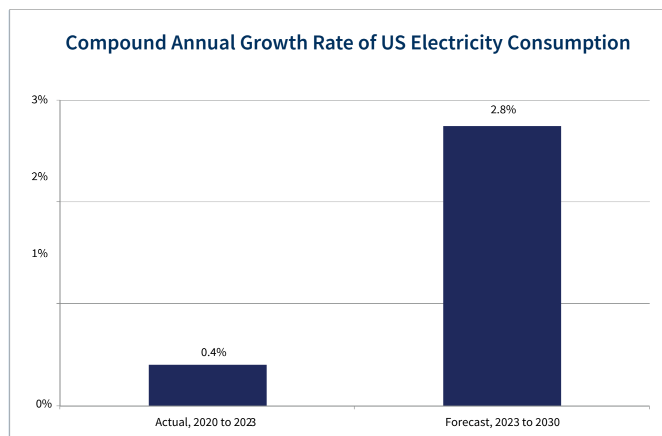
Source: American Immigration Council, data as of 08/29/2023

[1] https://www.brookings.edu/articles/almost-half-of-fortune-500-companies-were-founded-by-american-immigrants-or-their-children/
[2] https://nfap.com/wp-content/uploads/2023/06/AI-and-immigrants.nfap-Policy-Brief.2023.pdf

When It Comes To US Electricity Demand, Chatbots Matter More Than Cars

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

Whether or not you enjoy sitting in front of a computer and conversing with a human-seeming artificial intelligence platform (i.e. a chatbot), the AI boom will, if nothing else, affect your energy bill. AI is set to become a game changer for the electric power industry — especially, though not solely, in the United States. Principally as a result of AI, US electricity demand is about to start posting meaningful growth for the first time in two decades. Enabling the power grid to manage this growth in demand, while simultaneously shutting down ageing coal-fired power plants, will require an all-of-the-above strategy. At Raymond James, analysis of this trend has involved a collaborative, cross-industry effort between the technology and energy research teams.



Source: EIA, Raymond James Equity Research

DEMAND FOR ELECTRICITY SET TO SKYROCKET

It may come as a surprise to some of our readers that electricity demand in the United States and across developed economies more generally has been flattish over the past quarter-century — even as population and GDP have continued to grow. The reason is energy efficiency: everything from lightbulbs to air conditioners is more efficient than the older equipment being replaced. US electricity demand in 2023 was up only 10% from 2000, equating to average growth of only 0.4% per year. But AI is about to change that in a big way.

We forecast that US electricity demand will grow at an average of 2.8% per year through 2030, with AI-related demand comprising

two-thirds of incremental demand. The other one-third comprises electric vehicles and, well, everything else! Data centres supporting the AI boom are extremely energy-intensive, even more so than data centres that have been around since the early days of the internet. Simply put, whenever someone engages with a chatbot — and this is happening countless times every day — a hefty amount of electricity is used. Furthermore, data centres provide a textbook example of mission-critical electricity users: they cannot afford to lose power even for a minute. Data centres run by the large third-party providers and hyperscale cloud companies typically have sufficient on-site generators and temporary battery backup to remain operational during grid outages.

So, is this good news or bad news for the electrical power industry? The short answer is: good. Utility companies obviously want to sell more electricity to their customers, and as mentioned earlier, they have had very little organic growth (on the whole) for a long time. That said, utilities also face the risk of managing a power grid that is unprepared for the increasing demand. In the worst-case scenario, it could lead to systematic load shedding — deliberate power outages affecting a large proportion of the population, such as experienced most notably in South Africa — as a way of reducing the stress on the grid. We are not the only ones who see the risks. In

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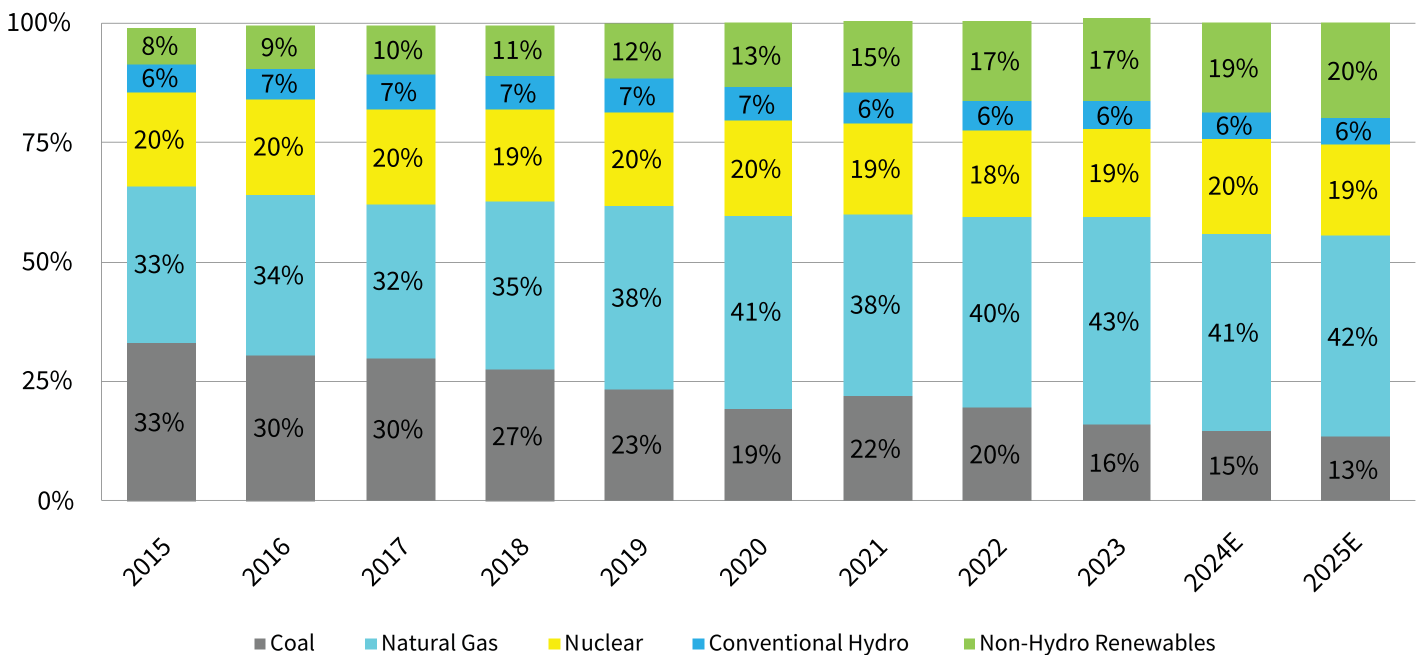
Where will the electricity come from? First, let's look back at the past two decades. During a period of stable electricity demand, coal's share of the US electricity mix plummeted from 50% to 16%



Source: EIA, Raymond James Equity Research

As part of infrastructure upgrading and modernisation across the board, what needs to happen is for connectivity between the regional grids to be greatly bolstered.

and was displaced by a combination of natural gas and renewables (mainly wind and solar). In 2023, natural gas provided the largest portion of US electricity (43%) followed by renewables at 23% and nuclear power (which is slowly trending down) at 19%. Looking toward 2030, coal is set to continue shrinking, plus overall demand is set to grow. Natural gas, wind and solar all must expand, by significant amounts — there is no single panacea here. In thinking about these various sources of electricity, there are geographic considerations to keep in mind. The AI data centre buildout is predominantly taking place in the eastern US, notably Virginia and Ohio. The proximity to the giant Marcellus shale resource in the Appalachian Basin makes natural gas an excellent choice to supply the turbines and fuel cells that will be needed for these data centres. While there is lots of wind and solar development taking place all across the country, an outsized proportion of the wind and (especially) solar development is taking place in the western half. Not as many data centres are being built there, but on the flip side, states such as Colorado and Wyoming have coal plants that need to be shut down.

POWER GRIDS IN DEPTH

An important but not always understood feature of the US electric grid is the extent of its geographic bottlenecks. The two major grids — Eastern and Western Interconnections — have minimal connectivity, for reasons that go back to the first half of the 20th century. As it stands, there is very little transfer capacity between them. Data centre operators in the east need to rely upon physical electricity supply that is also in the east. Likewise, coal plants being shut down in the Rocky Mountain region will be mostly replaced by the wind and solar projects located in the west. Texas, the ERCOT grid, is largely isolated from both the Eastern and Western Interconnections. This presented a major problem during the snowstorm in early 2021, when, despite sky-high power prices, Texas was unable to source urgently needed electricity from its neighbours. In the long run, as part of infrastructure upgrading and modernisation across the board, what needs to happen is for connectivity between the regional grids to be greatly bolstered.

AROUND THE WORLD

Let's also look at the situation internationally. Just as the AI boom is proceeding at varying speeds in different parts of the US, the same applies to different parts of the world. The US has approximately one-third of the world's data centres, followed by 16% in Europe and 10% in China. Meanwhile, the baseline growth rate of electricity demand can also be very different: since 2010, it was 6% in China, -1% in Europe, and 2% for the world as a whole. The mission-critical attributes of data centres face heightened challenges in many emerging markets. Above and beyond grid-related mishaps, there are parts of the world where electricity supply and demand are chronically out of balance, such as South Africa's long-running problems with load shedding, and the periodic drought-related difficulties facing hydropower in Brazil.

A MARATHON, NOT A SPRINT

What we have discussed in this article encompasses a multi-decade story. In the electric power industry, nothing changes on the spur of the moment — in other words, do not expect any immediate transformation. Utility management teams and policymakers alike are aware of what needs to be done, but complex infrastructure projects are always prone to delays. The capital to make these investments is available, and so is the technology, though labour can be a constraint. This is a proverbial marathon rather than a sprint, which means that a wide range of companies stand to benefit from these opportunities for decades to come.

KEY TAKEAWAYS:

- The AI boom will, if nothing else, affect your energy bill. AI is set to become a game changer for the electric power industry as energy demand, which has been flattish for 25 years, is about to increase.
- We forecast that US electricity demand will grow at an average of 2.8% per year through 2030, with AI-related demand comprising two-thirds of incremental demand.
- There's no single silver bullet for where the electricity will come from. Natural gas, solar and wind all must expand.
- This is a proverbial marathon rather than a sprint, which means that a wide range of companies stand to benefit from these opportunities for decades to come.

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