STRATEGAS ASSET MANAGEMENT

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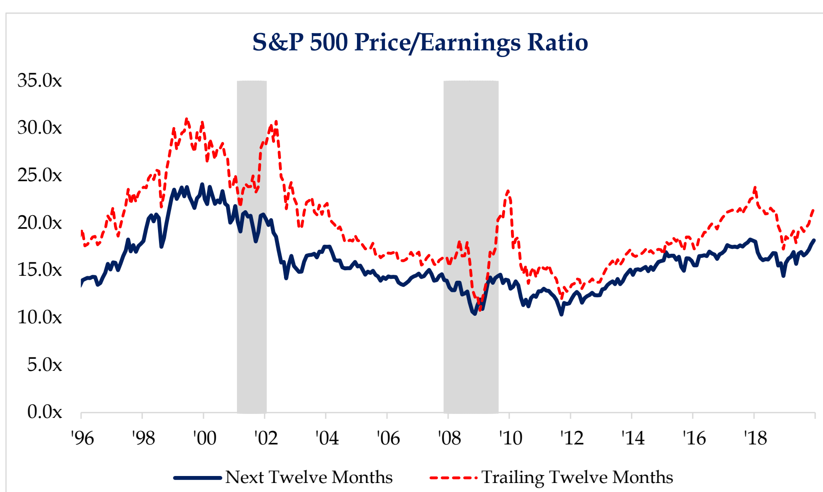
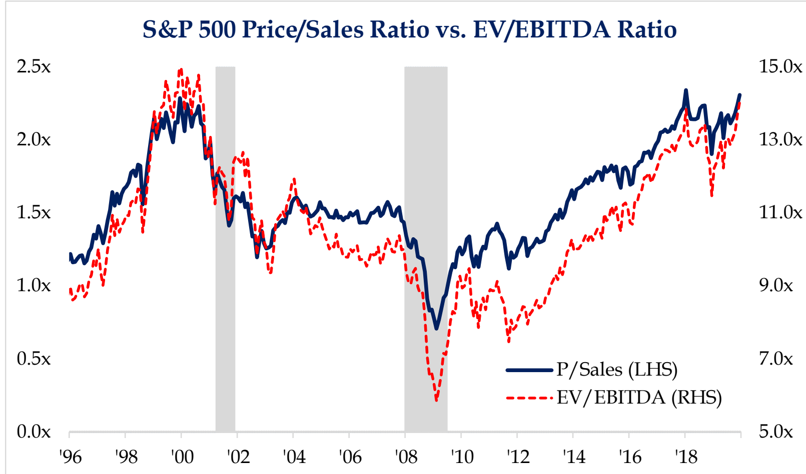
In this month's Insight, Nicholas Bohnsack discusses how he believes the current state of affairs is skewed toward continued expansion.

Nicholas Bohnsack is the President & Chief Executive Officer of Strategas Asset Management and a Managing Director of Baird.

The Marshallian Shift

Stocks just keep going up. Fueled by the Fed's 'mid-cycle adjustment' and the 'phase 1' agreement between the U.S. and China in their protracted trade negotiations, the S&P 500 has tacked on more than +10% over the last three months to top-off a near +27% advance over the last 12 months. The move in the Nasdaq has been even more robust, advancing more than +14% since early-Oct'19 and +32% Y/Y. To a growing number of investors, the recent move seems almost impregnatable; to us, there are hallmarks of previous episodes of late-cycle multiple expansion. This performance profile begs for vigilance. Candidly, we would not be altogether surprised to see the major indexes evidence a period of increased choppiness as 4Q'19 earnings are reported, and the Democratic primary season gets underway. While we are far from bearish given – by our lights – that there appear few exigent pre-recession signposts and that broader economic data actually appear to be bottoming-to-improving, we do not view the outlook for equities to be materially higher, in the aggregate, from current levels over the intermediate-term (3 to 6 months). Though it is difficult to describe shares as 'expensive,' on a price-earnings basis when considered against the standard pre-recession reference point (i.e. ~30x in 1999), it would be difficult to justify a furtherance of the current advance should corporate operators continue to be cautious with near-record corporate cash reserves, particularly in the context of price-sales and enterprise value-EBITDA regimes.





Historically, the combination of above-trend market advances and periods of notably lackluster earnings growth foster a tension which has generally reconciled in one of two ways: either, 1) fundamentals show sufficient improvement to substantiate the market's optimism; or, 2) prices re-set to levels that are justified by a revised outlook on the strength of the broader economy. We can envision a reversal of this relationship (stronger ΔE, less ΔPx), if growth reaccelerates into CY'20. To that end, the economy continues to give broadly mixed signals. Broadly, a number points of uncertainty remain worrisome: the recent military engagement with Iran is top of mind, despite the – mercifully – quick de-escalation; protracted production delays at Boeing will be an intrinsically meaningful weight on growth; and, ratcheting political rhetoric as the impeachment articles against the President are turned over to the Senate will likely weigh on the three legs of confidence – consumer, business, and investor. There, to be sure, a number of recent headwinds that have eased, however: following the Conservative party in the U.K, Brexit should proceed; the Fed has relaxed dislocation in the overnight market; and, Congress appears poised to pass the USMCA (aka New NAFTA).

In our view the current state of economic affairs remains skewed toward continued expansion, albeit the pace of the expansion has continued to slow. We may even be in the midst of a 'Marshallian shift.' Broadly expansive monetary policy creates an increase in "Marshallian k" – Alfred Marshall's measure of liquidity growth and the theory that the amount in excess of nominal GDP will find its way into risk assets – which tends to manifest in cyclical multiple expansion. The rising tide phenomenon dampens the urgency to pick winners vs. losers. That both phenomena have been extant as a derivative of the excesses that caused the Great Recession seems to provide a reasonable explanation for the market's outsized returns off the market's 2009 low. What seems critical to determine going forward, however, is whether these two boosters of passive management are ebbing? We think so. This should lead, in a secular framework, to more granular portfolio construction if, as Marshal posited, the opposite is true – the more the real economy grows the more liquidity gets siphoned away from financial assets. As our chief strategist, Jason Trennert, wrote earlier this week, the last two years were almost textbook examples of the phenomenon. Spurred by supply-side tax cuts passed at the end of 2017, the economy strengthened meaningfully in 2018 while the Fed tightened and money growth slowed. The whole process reversed in 2019 as concerns about a trade war slowed the economy, the Fed eased, and long-term interest rates fell. Investors, in turn, sought higher returns in financial assets and got them. Almost everything – stocks, bonds, gold, etc. – appreciated in price. With the trade war largely behind us and the Administration likely to maneuver the wheels of government to provide a tailwind for economic growth, we would suspect the economy to strengthen, long-term interest rates to rise, and returns on risk assets to fall this year. The greater the increase in interest rates the greater the dispersion in those assets will likely be.

Strategas Recommended Asset Allocation (Jan'20)

	Equities	Bonds
Overweight	Dev AC Core EM AC Core	IG Corporates TIPS
Neutral	US LC Value US LC Core US LC Growth US MC Value US MC Core US MC Growth US SC Core	Agencies ABS/CMBS US Dollar EMD Local EMD High Yield Convertibles Bank Loans
Underweight		US MBS U.S. Treasuries

While the outlook showcases potential, we are mindful that should corporate operators remain unmotivated to engage capital in profit maximizing endeavors, we fear the natural properties of economic gravity may take hold sooner than we thought. Improvement in corporate fundamentals, even if average by order of magnitude, could be enough to redress any concern shares look toppy. We remain vigilant to this point. The major gauges of corporate activity owe investors a strong quarter, or two, before we would give the all-clear. This may result in a softening of the aggregate advance – the recent run to a succession of new highs notwithstanding – and an increased emphasis on the security selection, as would be expected in the later stages of the business cycle.

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